United States Court of Appeals

for the Second Circuit

JOINT APPENDIX

76-7278

Volume A-5
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United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 76-7278

B

MARGARET MARY MCDONNELL MURPHY,
Plaintiff-Appellant,

against

MCDONNELL & CO., INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,
Defendants.

JAMES F. MCDONNELL, JR., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and CHARLES E. MCDONNELL, as Executor of the Estate of Anna M. McDonnell.
Plaintiff-Appellants,

against

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary, and MCDONNELL & CO., INC.,
Defendants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

JOINT APPENDIX

Vol. A-5

UNITED STATES COURT OF APPEALS
FILED
OCT 12 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

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October 8, 1976.

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(In the courtroom, in the presence of the jury.)

H. V E R N O N L E E, Jr., called as a witness, having been duly sworn, testified as follows:

Q Mr. Lee, were you an employee of the American Stock Exchange in 1968 and 1969?

A Yes, sir.

Q What was your position, please?

A In 1968 and 1969 I was vice president and secretary of the exchange.

Q Were you an officer of the exchange?

A Yes.

Q Sir, were you at one point a director of the department of outside supervision?

A Yes, I was.

Q When was that please?

A From 1950 until about 1962, I think.

Q Was that department still in existence in 1968 and 1969?

A No, sir.

Q What were your responsibilities as vice president and secretary of the American Stock Exchange?

A Well, as secretary I was secretary of the board and the various committees of the exchange. As vice president I was in charge of the membership services division.

Q Membership services division?

A Yes.

Q What did that entail?

A The division concerned itself with approval of new members of the exchange, partners of member organizations; approval of registered representatives, and in those jobs we reported to the committee on admissions.

We also had some responsibility -- I think that is the sum total of that division's responsibilities.

Q Sir, the American Stock Exchange had a constitution and rules and regulations, did it not?

A It did, yes, sir.

MR. BEEBE: I offer as the next plaintiffs' exhibit the American Stock Exchange constitution and rules dated April 15, 1969.

(Marked Plaintiffs' Exhibit 87 for identification.

MR. BEEBE: And the next exhibit, at the same time, the American Stock Exchange constitution and rules dated March 1, 1970.

(Marked Plaintiffs' Exhibit 88 for identification.

MR. BEEBE: And with the Court's permission I will substitute a Xerox copy of these, because I promised to return the originals to Mr. Loflin.

I offer these in evidence.

MR. LOFLIN: I have no objection, your Honor.

THE COURT: Very well, they will be received.

(Plaintiff's Exhibits 87 and 88 received in evidence.)

BY MR. BEEBE:

Q Sir, in 1969 if there was a violation of the New York Stock Exchange's net capital rule, would that also be a violation of the American Stock Exchange's comparable rule?

A Yes. I believe our capital rules were substantially the same as those of the New York Stock Exchange, and a violation of one would be a violation of the other, yes, sir.

Q Did there come a time in January, 1969, when you were advised at the American Stock Exchange that a certain Series B debenture at McDonnell & Company had been exchanged for Series E debentures? And I show you a document dated January 2, 1969 --

(Marked Plaintiffs' Exhibit 89 for identification.)

Q -- which is dated January 2, 1969, apparently from McDonnell & Company to Mr. H. Vernon Lee, Jr.

A Yes, I recall that.

MR. BEEBE: I offer that as plaintiffs' next exhibit in evidence.

Mr. Loflin, I will have an extra copy of this

furnished for all defense counsel and yourself.

MR. LOFLIN: No objection.

(Plaintiffs' Exhibit 89 received in evidence.)

BY MR. BEEBE:

Q Did there come a time when the American Stock Exchange acknowledged receipt of that letter? And I show you a document dated January 20, 1969, apparently from Howard A. Strauss, assistant director of admissions to Thomas A. McKay at McDonnell --

(Marked Plaintiffs' Exhibit 90 for identification.)

A Yes, I am familiar with that.

Q You are familiar with that?

A Yes, sir.

MR. BEEBE: I offer that as the next exhibit.

MR. LOFLIN: No objection.

(Plaintiffs' Exhibit 90 received in evidence.)

Q Was Mr. Strauss the assistant director of admissions for the American Stock Exchange at that time?

A Yes, sir.

Q The American Stock Exchange was a separate exchange from the New York Stock Exchange, was it?

A Quite separate.

Q Now, sir, did there come a time when the American Stock Exchange was notified by McDonnell & Company that it

was under its net capital requirements? And I show you a letter dated January 16, 1969, from McDonnell & Company addressed to H. Vernon Lee --

(Marked Plaintiffs' Exhibit 91 for identification.)

Q -- and ask you, do you recall that, sir?

A Yes, I do.

MR. BEEBE: I offer that as the next exhibit.

MR. LOFLIN: No objection your Honor.

(Plaintiffs' Exhibit 91 received in evidence.)

Q And did the American Stock Exchange acknowledge receipt of that letter by a letter dated January 20, 1969, which my copy does not have a signature on it but it appears to have the initials as the preparer of H.V.L.; it is addressed to Thomas McKay at McDonnell & Company.

(Marked Plaintiffs' Exhibit 92 for identification.)

A Yes, I am familiar with that letter.

MR. BEEBE: I offer that as the next exhibit.

MR. LOFLIN: No objection, your Honor.

(Plaintiffs' Exhibit 92 received in evidence.)

Q HVL was yourself, is that right?

A Yes.

Q I would like to pause and read that.

From yourself to Mr. McKay, January 20, 1969.

"Dear Mr. McKay:

"This will acknowledge your letter of January 16th advising this exchange the capital position of your corporation under Rule 325 of the New York Stock Exchange.

Your advising the exchange of the situation is appreciated and we would appreciate further your notifying the exchange of future developments as they occur.

Sincerely Yours."

Was the exchange that you were referring to in the last sentences there the American Stock Exchange?

A Of course, yes.

Q Did you receive, in turn, a letter from Mr. McKay dated January 21, 1969, the next day --

(Marked Plaintiffs' Exhibit 93 for identification.)

Q -- acknowledging receipt of your letter that was just read?

A Yes, sir.

MR. BEEBE: I offer that as the plaintiffs' next exhibit.

MR. LOFLIN: No objection.

(Plaintiffs' Exhibit 93 received in evidence.)

BY MR. BEEBE:

Q What did the American Stock Exchange do in response to these notifications concerning McDonnell & Company's net capital position?

A The exchange did not take any specific action as a result of this notification. And if I may I would like to explain that under the rules of the American Stock Exchange, which were widely published and readily available, and had been sanctioned over the years by the Securities and Exchange Commission, the American Stock Exchange deferred to the New York Stock Exchange in connection with surveillance of the financial condition and the conduct of member firms which were members of both exchanges.

Q Are you done, sir?

A Yes.

Q And if the American Stock Exchange failed to perform its duties, what did the American Stock Exchange do?

MR. LOFLIN: Could I have that question read?

THE COURT: Yes, you may.

(Question read.)

MR. BEEBE: I meant the New York Stock Exchange. My fault.

Would you repeat the question as revised?

(Question read as follows:

"Q If the New York Stock Exchange failed to perform its duties, what did the AmericanStock Exchange do?")

"A I would like to explain further that the American Stock Exchange in the case of firms that were members of

both exchanges did not require such member firms to file with the American Stock Exchange financial reports and information affecting this financial condition for the reason that the American Stock Exchange relied on the New York Stock Exchange in that area.

Therefore, the American Stock Exchange not having all of the information available to it, would not be in a position to take action at that point.

Q And if in relying on the New York Stock Exchange the New York Stock Exchange failed to perform its duties, what did the American Stock Exchange do?

MR. LOFLIN: Objection, your Honor. There is no foundation for that question.

THE COURT: Let me hear it.

(Question read.)

THE COURT: I am going to sustain the objection.

MR. BEEBE: I will try again on the form.

BY MR. BEEBE:

Q You testified that the American Stock Exchange relied on the New York Stock Exchange?

A Yes.

Q To perform the appropriate regulatory functions under Rule 325 --

MR. BROOKS: He has not testified to that.

THE COURT: No, he has not.

Mr. Beebe, you are going to get in trouble if you start summarizing his testimony in the questions.

Why don't you just go ahead and put your next question.

MR. BEEBE: It is in effect my final question. I will rephrase it:

Q If the New York Stock Exchange failed when you relied on them, what did the American Stock Exchange do?

MR. LOFLIN: Objection, your Honor, unless it can be shown that there was a particular context in which this alleged failure occurred.

There is no foundation for the question.

THE COURT: Sustained.

Q Did the American Stock Exchange perform itself any regulatory functions with regard to McDonnell & Company and the net capital violations that were shown in the exhibits we just put in?

A No, we did not.

MR. BEEBE: I have no further questions on direct of this witness.

MR. LOFLIN: I have no questions your Honor.

THE COURT: Mr. Brooks?

MR. BROOKS: No questions, your Honor.

THE COURT: All right, you may step down.

THE WITNESS: Thank you.

(Witness excused.)

MR. BROOKS: I have a small housekeeping matter, sir.

Exhibit 26 for identification, all parties agree that my offer to put it in evidence would not be objected to.

THE COURT: Received.

(Plaintiffs' Exhibit 26 received in evidence.)

MR. BEEBE: The plaintiffs rest.

THE COURT: Now, ladies and gentlemen, the plaintiffs having rested their case in chief, that is, having put in their proof on their case in chief, there are certain matters that will require the attention of court and counsel, and to that end I think we have to give a fair amount of time, and you will be in recess until Monday at 2 in the afternoon.

I have, as an estimate, that we hopefully will finish the case next week or possibly on the Monday, the day after.

I trust that it does not work any irremedial hardship to any jurors who next week will be going into

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the third week of their service. That is the prognosis, that we will possibly finish next week or no later than the Monday following.

So you could have that in mind as you go into the weekend.

I will ask you again not to discuss the case with each other or with anyone else. I will see you at 2 o'clock on Monday. Have a good weekend.

MR. BEEBE: What time did you want counsel to gather on Monday?

THE COURT: 10:15.

(Adjourned to Monday, May 12, 1975, at 10:15 A.M.)

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MARGARET MARY MC DONNELL MURPHY, et al.

vs. 71 Civ 461
71 Civ 1940

MC DONNELL & CO., INC., et al.

May 12, 1975
10:15 a.m.

Trial resumed.

- - -

(In open court; jury not present)

MR. BROOKS: Your Honor, with the agreement of my co-defendants, I have been elected to lead off this morning. I have put before you all of the defendant exchanges' original exhibits which have been marked in evidence. Mr. Beebe stands ready to supply you with whatever plaintiffs' exhibits you should require.

Since plaintiffs have now rested, the stock exchange, the New York Stock Exchange moves for a directed verdict under Rule 50A of the Federal Rules of Civil Procedure and renews its motion for summary judgment which it has filed before and which the Court

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has reserved decision on pending receipt of the evidence.

The grounds for the motion are very simple. We think the plaintiffs have not introduced sufficient evidence to prove by a preponderance of that evidence the prima facie claim against the exchange exists under the applicable law.

I submit, your Honor, that the Court should grant the motion because reasonable men could not reach a different conclusion, and I believe that is the standard for a motion for a directed verdict in this circuit and is best articulated in the case of Radiation Dynamics vs. Goldmunts at 464 Fed. 2d 876, a 1972 Second Circuit case.

My argument divides into two parts: the fraud claim and the regulatory claim and those two claims in turn divide into two parts. One is there was no fraud; and two, even if there was fraud the stock exchange has no legal responsibility for that fraud.

On the regulatory case we say that there was no breach of a duty under Section 6. But even if there was a breach we say that breach did not injure these plaintiffs so as to provide the necessary element of proximate cause which they must prove as an element of their section 6 case.

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Now, the even if arguments are primarily arguments of law, I think, but they nevertheless can be dispositive of the whole case against the exchange. The arguments as to fraud and proper regulation consist basically of assessments of the evidence and asking whether reasonable men could differ.

On the fraud claims we have looked at the evidence and we see a failure of evidence to prove fraud; that is, that there was a misstatement or omission to any of the plaintiffs. And beyond that that there was no materiality as to these plaintiffs as to the alleged material to which they were either given misdisclosure or non-disclosure.

I will treat each plaintiffs' claim separately. I am prepared to cite to the evidence for every proposition that I put to your Honor. I have citations in my outline. I think at some point I will provide them in my orgal argument and at other points I will not because it will be too disjointed. However, I am prefectly prepared to tender my outline to your Honor at the end of the evidence, should you wish each point annotated.

I am going to start with a rather technical point for plaintiff Anna McDonnell, and that is she has no standing under Rule 10(b)(5) because she has not

purchased or sold any security that is at issue in this case. Your Honor will recall the evidence shows that Mrs. McDonnell signed a subordination agreement in 1962, which is Exhibit JJ; a subordination agreement in 1965, which is Exhibit OO; and a subordination agreement in 1966, which is Receiver's Exhibit B1.

Now, that 1966 agreement continued in effect because it had no specific termination date. It was to be terminated on 100 days notice. In 1969, the transaction here challenged, Mrs. McDonnell simply deposited additional securities in the subordinated account which had been subordinated in 1966. She was just as a depositor in a savings bank coming along and putting another $10 or $15 in her savings account.

Now, inthe case of Hughes v. Dempsey Tegler, we made the argument that a subordinated transaction is not the purchaser's sale of securities, that it's merely a pledge. There Judge Lucas said no, that's not so. Subordination agreement is an investment contract. But here, your Honor, that investment contract was entered into in 1966. There is no claim of fraud in 1966.

Now, getting to the real evidentiary matter as to whether any fraud was worked upon Anna McDonnell in 1969, what does the evidence tell us? Mrs. McDonnell

was fully aware of the risks of subordination and does not deny that she had full awareness of the financial and operating condition of McDonnell & Co. in January of 1969. She does not deny that.

Let me make that more particular. There was a meeting in her apartment in 1962 testified about by James McDonnell where Murray, Tom Ford, James, Bob Aaronson, her accountant, got together to make sure that when she entered that first subordinated transaction she knew what the scheme of things were; that her money would be at risk, what a subordinated transaction was.

Now, in May of 1963, James wrote a letter to his mother. That's Exhibit HH, in which he speaks about his apprehension of her status as an unsecured creditor of the firm. But she testified, in the transcript at page 214, that she was fully aware of these risks on her own, and in 1969 she testified that she knew the condition of the firm was worse than it had been in 1962. That's at transcript page 1041 and 1042. She said, "Because I knew things were worse in 1962 or I wouldn't have been asked for more money."

She then said:

"Did you conclude that the reason why they needed additional capital was that conditions had worsened

at the firm?"

"Yes, I did."

At 1043 she testified that she cannot say that Murray did not give her information about worsening conditions, and at 1044 she said she does not recall whether Murray told her about operating profitability, violation of exchange capital rules, and operating problems.

We know she apoke to James on January 29th about contributing additional capital, and that James wrote her a letter on January 30, which is Exhibit I, cautioning her about long-term capital problems at McDonnell & Co., and unnecessary risks.

Now, your Honor, I submit that when there is a case of fraud and the plaintiff says she cannot recall or does not know one way or the other whether she got the intofmration which he complaint claims she did not get, she cannot as a matter of law prove by a preponderance of the evidence that she has been defrauded. The "she cannot recall" cannot prove anything by a preponderance and there is no other evidence in this record.

THE COURT: Let's leave this point on this footing: Mr. Beebe, I am troubled by the one sentence

that I remember being testified to which is that she was aware in '69 conditions in the firm had worsened. I will hear you on whether that isn't all that is needed to destroy a fraud claim, because in the absence of anything else she certainly is on notice that something needs looking into.

But let me hear you on that. I am going to pass that for a moment because I want to go on to others that are more troublesome. But I have a feeling that that one statement on her part may be -- not must be, but may be dispositive of this issue.

MR. BEEBE: I will be pleased to address that.

THE COURT: Yes, I want to hear you on that.

MR. BROOKS: Your Honor, I think the next vital element in a fraud claim is whether the information claimed to be misrepresented or omitted is merial information. The Second Circuit has said on April 1st of this year that you must look at that question of materiality when you have a people to people kind of transaction as compared to one of these prospectuses which you have challenged or something that 20,000 people read. You have to look at these people to people transactions to determine whether the information was

material to the person inolved in the transaction.

If I might quote from the case of Titan Group v. Fagen, which was that Second Circuit case on April 1, there the Second Circuit said that there was an abundance of evidence of the matters that plaintiff really considered important in entering this face to face transaction; that while omissions in other circumstances have been demed material, the omissions were not material in these circumstances. And we so argue in respect to theinformation that the plaintiffs had labored over for two weeks the financial and operating condition of McDonnell, the financial condition should be qualified in respect to a capital violation of the stock exchange rules.

I don't think there has been any showing that the financial condition of McDonnell was not sound.

THE COURT: Mr. Brooks, can we establish for purposes of this morning's argument that the "omitted" information, so we know what we are talking about in terms of omissions, are those that are set forth at page 14 of your memorandum, Mr. Beebe, which is that there are four of them.

Mr. Brooks is not blessed with a copy and

vice versa, but the first one is that there was a violation of the capital requirements. The second one was that his back office had deteriorated to a state of chaos. The third that there was little likelihood they would be able to withdraw the subordinated securities in the foreseeable. Four, that a high degree of risk was involved in the transaction.

Are those what we are talking about or is there more?

MR. BEEBE: I would add based on the evidence that emerged at the trial that there were two partners who were withdrawing with $400,000 of funds, according to Mr. Schuette's testimony and Exhibit 37, this is in early January 1969, and there was the loss of key personnel as we saw the exchange knew and was concerned about, withdrawal of two partners, taking some $400,000 with them, and that's Exhibit 37 and the evidence so far has shown that there was the loss of seven or eight of the top executives after Sean McDonnell died. He in turn was a top executive and McKay, even as early as November 7, according to that Schuette memo --

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THE COURT: So, then, we have six material omissions, according to the plaintiff. So I will read them again.

MR. BROOKS: I will not concede those were the facts at the time, your Honor.

THE COURT: I understand.

MR. BROOKS: Let us proceed on the basis that they were. I submit they would not be material when it came to something, whatever was needed.

THE COURT: Don't you think that last issue is a jury issue? If they are material to anyone, they might be material to McDonnell, and she may have had no concern with them. She knew the conditions had worsened and she was a mother who was going to try to keep the family investment going. But I think you are on weak ground.

MR. BROOKS: Let me try to move you from that position by reading to you some of the testimony that has been put in the record by Anne McDonnell, on page 1041. She was asked about making the subordinated transaction and she responded:

"Any child had what they wanted if I could give it to them, help them out."

And at page 1053 she said:

"As T. Murray McDonnell is my son I agreed to subordinate my account at McDonnell in 1962 and 1965 and as

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was the case in 1969, to contribute to my already subordinated account."

Your Honor, I point out to you that there has been no testimony by this plaintiff or by any plaintiffs that had she known of these things that she would have acted any differently. I submit on this record it is perfectly clear if she did not know about them and had been told, she would have acted bigger and faster, she would have put more money in faster. There is nothing in this record to show that she would have acted any differently. The plaintiffs have to prove by a preponderance that issue of materiality. They can't just leave it hanging and say, "I might have held up a little; I might have considered it a little further." No, she hasn't said anything like that, and all the inferences are to the contrary. But, your Honor, that is not a jury question, because there is no evidence to get to the preponderance that it could be material to her. I suggest the answer is she will have done more.

Now, there has been testimony of a meeting at the Carlton House Hotel about July of 1969, where the family was gathered together, and Paul McDonald came in and essentially told the family of the condition of the firm and where he was going to take it. I submit that meeting

was testified to by James at page 225 of the transcript.

THE COURT: Mr. Dubin, it would assist us all if you would unveil the charge here for the purpose of this morning's argument.

MR. BROOKS: I submit after the July meeting at the Carlton House Mrs. McDonnell could not deny everything there was to know about the firm, that Paul McDonald, in essence, laid it on the line.

Now, when she authorized Murray to sign the re-capitalization agreement, September 30th, as of October 15th, documents which were testified to at transcript 1049, Exhibit 4, she stated that she did authorize Murray to sign her name. I suggest there can be no doubt at this time that the full facts were known to everybody.

We come now to the "even if" argument for the stock exchange, and that goes even if Murray did not give it to his mother accurately and straight, in January of 1969, the stock exchange has no liability under the fraud laws to Mrs. McDonnell.

MR. BEEBE: No relation of that Beebe to me.

MR. BROOKS: I will concede that for the argument only. I think those cases make clear that the exchange is not a party to a transaction such as this, does not know of the possible fraud that is being worked, does nothing

to assist it, has no responsibility for what an officer of a member firm might do out there in the bull rushes to a prospective capital contributor. I suggest that was the case here. There was absolutely no communication between the stock exchange and Mrs. McDonnell in connection with any of her transactions. She had been an investor in the firm since 1961. She was the matriarch of the McDonnell family. The exchange had every right to assume that with that background she would know what she needed to know to invest a little bit more in McDonnell & Company. I think the exchange also has a right to rely on a respected chief executive officer of a respected brokerage firm to provide fair disclosure to the mother of that officer, a person who had been associated with that firm for 50 years, especially when it knows that the firm is guided by capable legal counsel and does underwritings all the time and should know full well what the disclosure rules are.

Now, the exchange until it received notice that there had been deposits to two existing subordinated accounts for Margaret Mary McDonnell Murphy did not know where that $500,000 of necessary net capital was going to come for. It was told after the deposit had been made. There was no approval required of Mrs. McDonnell. She had been approved back in 1962. And, in any event, the agreement,

Receiver's Exhibit B-1, provided in paragraph 10 that the agreement was effective whether or not the stock exchange approved Mrs. McDonnell.

There has been a lot of testimony in this case about knowledgeability letters, that there was a knowledgeability letter required by the stock exchange of capital contributors of McDonnell Company, people who had renewed capital contributors that had expired. That is 56A. That has a form attached to it which I think your Honor characterized to avoid a trial and dispose of these cases by summary judgment. I think it is an accurate characterization, but if you take a look at the letter attached to 56A, Mrs. McDonnell is not one of those persons. If you take a look at the letter attached to 56A, the covering letter, it would not have required a knowledgeability letter from McDonnell in January of 1969, because she was not a capital contributor for the first time, and she was not renewing capital contributors. And, in any event, I suggest on a materiality issue if she had been asked to sign such a letter it would have made no difference. She did not testify that it would make a difference. There was no attempt to get her to look at this letter and say, "By God, if Murray came in with that letter I would have sent him packing." I think all the evidence indicates an

inference to the contrary.

Now I will move on to Mrs. Murphy. I think on the question of fraud the information that she claims was given to her by Murray and by Rick Olney is not misleading; it is true. Assuming that she was told that capital was needed for the underwriting, that has not been shown to be untrue by the plaintiffs. McDonnell was doing underwritings all the time. It may very well have needed her capital for an underwriting.

THE COURT: That is a substantial jury question. It seems to me if the stock exchange said, "We want X thousand dollars a week,"and it was forthcoming from Mrs. Murphy, and used for something else, the jury can find that McDonnell & Company was misrepresenting the purpose for which it was being solicited.

MR. BROOKS: Let me move on, because the situation had changed by February 4th, when Mrs. Murphy signed the documents and presumably put her money in the firm.

THE COURT: I don't think you really ought to waste much time on that. I feel strongly that is a jury question.

MR. BROOKS: Is your Honor aware of the subordinations, that they put in enough capital to meet the 500,000 requirement, to bring them back in compliance, and $450,000 extra net capital on January 30th, so that when Mrs. Murphy

came along on February 4th she was putting her money into a firm that was $500,000 to the good on the net capital rule? I suggest that makes quite a difference whether she is told of a capital violation or not. Somebody might say, "Well, she needs a little historical review," but not with this relationship.

THE COURT: You are saying that the stock exchange demands for immediate capital had already been met?

MR. BROOKS: Yes. I think you can see by taking Exchange Exhibit C, which is a letter to the stock exchange saying that on January 30th they have deposited into these accounts $950,000, and all they needed was $450,000. They got almost half a million to the good.

Now, Mrs. Murphy said that Rick Olney told her there was no risk involved and that the paintings and furniture and the stock exchange seats could be sold to pay back her loan if necessary. Rick Olney's opinion as to whether there was no risk or not was his opinion, and there is no reason to disbelieve that was not his opinion. Plaintiffs have put in no proof to show that it was not his true opinion. I think when you are talking about opinion evidence or opinions you have to show the speaker did not reasonably hold the opinion. There is no evidence on that whatsoever.

I think it has been shown by all of the witnesses that the paintings on the wall, the furniture and the stock exchange seats could be sold to raise cash, and the cash could be used to pay off Mrs. Murphy. I don't think there is any doubt about that.

Now we come to the materiality argument with Mrs. Murphy, and again we are relying on the Titan case. Mrs. Murphy testified that she agreed to subordinate her account as a favor to her brother Murray. I submit that there has been no testimony that they would not have done Murray that same favor had she, assuming she didn't get the information, had the information. She has not said, "If I knew that I would not have done the deal." And all of the inferences are to the contrary.

I think what is material to a subordinated investor in a brokerage firm is not whether it complies with the artificial measurement of net capital under Rule 325, but what the net worth of the firm is, what are the assets of the firm. Exchange Exhibit AA, the white sheet showing the exchange examiner's analysis, shows that at the same time it had a capital ratio that needed improvement under Rule 325, it had a net worth of $16,000,000. I think in Mrs. Murray's case, too, we bring into application the body of law that says that somebody who is making a

securities transaction has to exercise some due care commensurate with their education and background before they go and try to shift the loss to someone else.

THE COURT: Let me ask you a question that troubles me on the materiality argument. Mrs. Murphy has given testimony that, "If I had known any of the items 1 through 6 I would not have done it." Or is it sufficient that a reasonable person has testified to the fact, "Rick, is there any risk in this?" And he says, "No," does that carry you to the jury on the theory that it is now their question as to whether, in fact, there was risk and that would have made a difference?

MR. BROOKS: I think the question of omitting to deny is evidentiary. I don't think it knocks it away from the jury.

THE COURT: It seems to me that a reasonable man could conclude that if Mrs. Murphy knew that there was a possibility that $300,000 could go down the drain on this, she might very well not have done it.

MR. BROOKS: There has to be enough evidence to get to the jury and permit them to be able to say that is what Mrs. Murphy would do.

THE COURT: I would think on her statement that she asked Rick Olney and he said no, that ought to get

her to the jury on that issue. Maybe there are other issues that take all issues from the jury. But it seems to me on that issue where she is concerned about risk, that there was, in fact, the possibility of a risk, you can assume it would have been material to her.

MR. BROOKS: I think it is an awfully slim reed that a reasonable man would find by a preponderance of the evidence that these things were important to her when you balance it off against all the other things that she has testified to. For instance, there was the conversation between her and her husband and the question was asked, "Should we investigate?"

THE COURT: And she said, "Don't you trust my brother?"

MR. BROOKS: "Don't you trust my family?"

rdrl

MR. BROOKS: I think all of the indicia that we have in this record, and there aren't a heck of a lot --

THE COURT: That works both ways. Did she trust in front?

MR. BROOKS: -- show the things she was relying on, the things she considered material, whether her brother was asking and it was a family firm, "Don't you trust my family?"

She signed these documents without even reading them, she has told us. She signed where it says X and went back to bed.

Now, I think when you call on someone else to stand for your loss in an investment, the person is entitled to have you exercise a little reasonable care.

THE COURT: Mr. Brooks, we are only discussing the narrow question of materiality. Reasonable care is another matter. You will get to that, I'm sure, in due course. I am just probing this one argument that I don't think is going to carry the weight that you attribute to it.

MR. BROOKS: I will move on, your Honor. If Mrs. Murphy were signing things just because there was an X thereon that morning in February, it didn't

matter whether there was a knowledgeability letter put in front of her or not. She would have signed where X was. She wouldn't have read it. She didn't read any of the other documents.

Now, her failure to read these documents caused her never to exercise the 100 days notice clause that was in her agreement by which she could have extricated herself from this predicament when she learned in early spring that her sister-in-law, Sandy McDonnell, Sean's widow, had found out that things were all not well at the firm of McDonnell & Company. 100 days she would have been out, late August. Instead in late August, instead of getting out she signed the reorganization agreement where she became an equity holder rather than a subordinated lender.

Now, your Honor, passing by the questions of fraud and materiality in the initial transaction, I don't think there is any doubt in all the testimony we have had in this case that by the time Mrs. Murphy signed those reorganization documents in September and October she knew that McDonnell was in bad shape.

She was told that by Sandy McDonnell in early spring. She was told that by Jim and Morgan during the summer. She was told that by Paul McDonald

when she met with him on September 30 and was asked to sign these documents, and told why.

Now, the documents ask the exchange to suspend certain restrictions, in view of what the McDonnell family was going to do to the capital structure of the firm to improve it. That was the deal that Jim testified that he told her to go along with, transcript page 183.

All these things aside, whether your Honor is convinced on the fraud or on the materiality, I think that it's perfectly clear that the stock exchange has no responsibility for it if it were worked upon Margaret Marcy McDonnell Murphy and his assistant, Rick Olney, because the exchange had no communication whatsoever with Mrs. Murphy.

To a person not a party to the transaction, it can have no liability as it cannot to Anna McDonnell's transaction on the basis of the Lanza case, Wessel case and the Beebe case.

Again, Mr. Murphy's agreement, subordination agreement, which is Exhibit 3, in its paragraph 10 provides that the deal is effective whether the exchange approves Mrs. Murphy or not, so when she signed her name where it said X she was locked into the deal for 100

days whether the exchange approved her as a capital contributor or not. That was still part of the capital structure of McDonnell & Company, therefore creditors. The only difference would be if the exchange didn't approve Margaret as a person of good character, it couldn't be considered as Rule 325 capital. But it was still there as capital for creditors.

So I cannot see how any responsibility for the fraud claim can attach to the stock exchange on the basis of the transaction entered into between a sister of the head of the firm in New Jersey on a morning when a chauffeur came to deliver documents, when the exchange was presented with it as a fait accompli with no indication whatsoever that there was any hanky-panky going on between Murray McDonnell and Margaret Murphy, if there was.

That brings us to James's claim for fraud. Now, our position on James is that he received all of the financial and operating information about the company that any investor should have received and that James is certainly the sophisticated investor that knew what to do with it. I think the testimony is clear on that, that this is a shrewd businessman who was used to dealing with financial statements and knows what to make of them.

Under cases such as Pollack vs. Eastman Dillon, when someone brings a fraud claim and attempts to shift the burden of their loss, they must adhere to that kind of standard if they are that kind of person.

James admits receiving Plaintiffs' Exhibit 16, which is a letter from Tom -- he admits receiving a letter from Tom McKay on April 11, 1969, with a number of documents which were financial statements and descriptive information about the firm of McDonnell & Company attached. All that was drawn together in James's claim to the liquidator, which is Plaintiffs' Exhibit 16. There was attached to 16 a certificate of incorporation, statement of financial condition for the last five years, a P&L statement for all of those years through the last eight months in 1968, a statement of the sources of capital of the firm, and an October '68 descriptive booklet.

Now, I think we have established, despite some elusive footwork by James, that sometime before he entered into this purchase of stock in the spring of 1969 he had gotten that financial statement, which is Exhibit J. In his interrogatories he swore that he got it on February 25th. In his claim to the liquidator I think it's fair by inference to say that he had gotten

it before he had made his purchase because he was basing his claim for fraud on that statement being misleading.

So that when he invests he knows the financial background of the firm, he knows from that first note in Exhibit J that the firm had had a capital violation which had been corrected by February 6th. And as a sophisticated investor, as one who is in the custom of scrutinizing these McDonnell & Company financial statements, as we saw from a letter from him to Murray in September of the year before, or denying Murray's request to subordinate sister Genevieve's account, where James made an elaborate analysis of the financial statement of the firm for the prior year; he knows what to make of these financial statements of McDonnell & Co. We also know that he was very concerned about the risk to his mother from an investment in the firm.

So that I think James knows all of these matters when he puts his money in. He also knows from Murray's situation to our valued customers on Exhibit J that this firm has been suffering serious operational problems, and James is no neophyte when it comes to securities, when it comes to investments. He knew very well what was going on in the paperwork crunch at that time. I'm sure he knew from that message at least

what was going on at McDonnell & Company..

Now, there has been absolutely no proof that any of the information given to James, any of those statements that came in with Tom McKay's letter which are attached to Exhibit 16, the financial statement which is Exhibit J, are false and misleading.

James said they were, but we haven't seen any proof to show that Haskins & Sells -- Lybrand's financial statement has any misleading information in it. We haven't seen any proof to show that all of those financial statements that Tom McKay send to James McDonnell are not perfectly true and accurate.

James has not testified either that if he had been toldof these problems at McDonnell by his brother Morgan when he had those two lunches with him in Detroit, that he wouldn't have gone ahead and put $20,000 in the firm. He was doing that, as he testified at page 251, as a favor to my brother Morgan.

So I think the Titan case, the rules about materiality apply to James. Even were the Court to think that the question of fraud as to James had to go to the jury.

Now, again, we come to the"even if"portion of our argument as to James. Even if there was fraud

and even if it were material to James, the exchange has no responsibility for it. There was no communication between the exchange and James as to this transaction where he purchased his 300 shares of stock. There is no reason for the exchange to think that McDonnell & Co. would treat unfairly James F. McDonnell, Jr., or that if it wanted to it could on James F. McDonnell, Jr.'s background.

Now, there is nothing in this record to alert the exchange to any possible wrongdoing here in the transaction between McDonnell & Co. and James. So that I think that even if your Honor should have a raised eyebrow about the fraud or the materiality arguments, when you come down to asking jurors is there any case against the exchange on the fraud claim I think there is not one, as they say, scintilla of evidence that we need to submit to the jury on that.

Now, that concludes the fraud analysis of the three claims. I submit that they have not proved any fraud; that even if the information they claim they didn't have, they really didn't have, wouldn't have changed their conduct on any of the evidence that we have seen. McDonnell's transaction was based on her theory that any child had whatever I could give them. Margaret's was

based on I did it as a favor to my brother Murray. Don't you trust my family? And James's transaction was based on doing a favor for his brother Morgan.

This brings us to the debenture question which we have heard a lot about. I think that is probably a cross between a fraud claim and a regulatory claim, whichis how I thought I would treat it here.

THE COURT: The claim of contributory negligence on your part.

MR. BROOKS: I will throw that in with the broad regulatory claim that we didn't do a proper job.

THE COURT: James testified he wasn't keeping track of this debenture rollover. Is that what you are talking about,the rolling over?

MR. BROOKS: Yes.

THE COURT: He didn't catch on to June that it had expired six months earlier.

Go ahead.

MR. BROOKS: I think it's a very basic point. The plaintiffs have not proved or plaintiffs have not submitted sufficient evidence so that a reasonable man could say that by a preponderance of that evidence the rollover was not authorized by Murray and Mrs.

McDonnell. I think we all concede that Murray voted yes. A lot of papers are in the files that show that Murray told Tom McKay to exchange it, as they did iwth all of these series B debentures.

We have also seen, transcript at page 1054, where Mrs. McDonnell testified, and also testimony by James, that the trustees did all their business orally by telephone. Then Mrs. McDonnell testified that she could not recall whether Murray advised her that he was going to roll over the debenture. That's at page 1051. And in her claim to the liquidator she testified that she doesn't recall whether prior to August 4th she had been advised of the rollover. That claim to the liquidator is Exhibit 11A.

THE COURT: Somewhere along the way she said she wasn't aware of it, didn't she?

MR. BROOKS: She may have said that, your Honor, but if she has she has contradicted it in at least two places.

THE COURT: I think that is a jury question whether fraud was committed in the rollover.

MR. BROOKS: Let me move on then, your Honor. I think it clear nevertheless that the exchange has no responsibility for an unauthorized exchange of

the debenture. There is no contention in this action that the underlying trust instrument, the will of James F. McDonnell, did not authorize that his assets that had been in the firm would remain inthe firm. So that we do not have the problem that the exchange raised later with another trust.

The exchange had no reason to believe that Murray McDonnell wouldnot be acting with authority or that the trustees did not vote unanimously to roll over the debenture. It could in good faith rely on Murray McDonnell as an agent of the trustee, as the chief executive of the firm to do what was the proper thing to do as he would know it and his lawyers would no doubt counsel him.

Furthermore, and I think overwhelmingly dispositive in this case, is the exchange could reasonably rely on the audit report of Messrs. Lybrand, Ross Brothers & Montgomery, which in the second footnote in Exhibit J, or in the more formal report, Exhibit Z, said that there had been a valid rollover of the B debentures a new E debentures, except for $80,000 which was somebody else's.

Now, Mr. McElroy testified thathe would certainly accept the auditor's report on that and

wouldn't waste his valuable time in this period of stress in the industry chasing around to see whether Lybrand, Ross had done the right job.

There is no evidence whatsoever to show that the exchange had any discussion with Murray about the rollover or knew about it until the Lybrand report satisfied them that it had been valid.

THE COURT: What you are saying, as I remember there is a New York authority that you cited to the effect that Lybrand could rely on what a trustee told it and incorporate that in its report and that the stock exchange could rely on Lybrand, and therefore you are doubly insulated, which is the position you take.

MR. BROOKS: Yes. We don't know what Lybrand relied on. They could have verified it from Anna McDonnell herself. We don't know. When they certify it in the report, we are entitled to rely. That's a principal working tool of the exchange's regulatory program.

I think before these trustees can come to the exchange with a summons and complaint in 1971 saying, hey, that debenture back there in January of 1969 was rolled over improperly, we are entitled to a little notice before then so we could do something about it to

save that $318,000 for them if they really wanted it saved.

But Anna McDonnell testified and James testified that no one every notified the exchange. They were running around talking about it among themselves in the fall of '69 and they were telling the auditors and telling Shearman & Sterling, CC's on these letters to everybody but the exchange.

I suggest if they wanted the money back the exchange was the first place to ask for assistance.

Now, the trustees, your Honor, I think are estopped from claiming for this debenture now because when they knew of the rollover and they could have gotten their money out, they didn't. Jim testified that he got a complete list of assets of the trust late in 1968, and of course the debenture was one of them. It was due to expire at the end of that year 1968.

Mrs. McDonnell got Exhibit U, which was a receipt for the debenture certificate on December 5, 1968, 25 days before it was due to expire.

I suggest that when Jim read those financial statements, Exhibit J, sometimes February 25th, April when he got his account statement, he must have known through that footnote that the debenture which he had

taken an inventory of had been rolled over.

In any event, he testified thatin June he knew it had been rolled over. But all of these documents that were passed back and forth, talking about this debenture, never asked for money, never asked for cash. They just wanted a little better piece of paper, alittle better than that series E debenture.

I suggest after that kind of performance it ill behooves these trustees to come to the New York Stock Exchange, the earliest in the spring of '71, with a summons and complaint and say give me cash.

I think there are New York cases which preclude this, the matter of Junkersfeld, which we have cited,and others, that make that kind of claim unconscienable.

This brings us to the preferred stock which, while it's on the chart, doesn't really seem to have a place in the lawsuit. The preferred stock came into the estate's inventory in 1959 when the partnership of McDonnell & Co. was incorporated and it needed to figure out what to evidence James F. McDonnell, Sr.'s partnership interest with. They elected the series B debenture, which we have talked about, and the 790 shares.

THE COURT: Am I correct, Mr. Beebe only has this in here on the regulatory rubric and not under any law rubric?

MR. BEEBE: Yes.

MR. BROOKS: As long as it is clear we don't have a purchaser sale of the security, we will get into the regulatory case.

Let me just touch on a point Mr. Beebe just made where they could have sold it. Your Honor takes a look at the terms of the preferred stock or if your Honor takes a look at the New York Stock Exchange rules which are incorporated in the terms of the preferred stock. You couldn't sell that stock to anybody like you could sell AT&T. It was restricted. It had to be redeemed by the company, because you can't have preferred stock in a New York Stock Exchange member firm just sold to anybody. I think the question is could it have been redeemed or not?

Now, let me get into the regulatory case. We did make a standing argument in our motion for summary judgment addressed to all of the plaintiffs. Since that time Judge Lasker's decision has come down, which I have supplied to your Honor and Mr. Beebe, so we are all on the same terms.

I think Judge Lasker's decision makes clear, although your Honor has to take a little analogous step, that James McDonnell's claim after he became a voting stockholder in McDonnell & Company, which Exhibit 18 shows to be on May 1, 1969, lacks the standing to make a Section 6 claim for failure to properly regulate after May 1.

I say that to your Honor because in the Sloan case Judge Lasker held that general partners of a brokerage firm, which is a partnership, do not have the standing to make a Section 6 claim. They are the people to be regulated and not the beneficiaries of the regulation. When they sign up with the exchange as such, they undertake a duty to make sure that the firm runs smoothly and according to the rules.

Of course, when you have a corporation which is a member firm, you don't have partners. What do you have instead of partners? Voting stockholders. Same thing as partners.

I suggest to you on the reasoning of the Sloan case, James McDonnell lacks standing after he became a voting stockholders to maintain Section 6 claims.

Now, Judge Lasker said to the contrary, to

subordinated lenders and limited partners, and in the facts before him I think that may be well taken. But with Anna McDonnell and Margaret Murphy I do not think we have the ordinary subordinated lender and certainly not a limited partner.

I continue the motion as to standing as to the two of them on the basis that they are insiders, that they always have been insiders, that this was a family capitalized firm, and that the standing issue has not been precluded as to them. I continue to urge it on that basis.

If I may just run through quickly what I view to be the applicable standards of law to judge the stock exchange's regulatory performance, and I think it will set a background for the facts.

The exchange, I think it is clear, has a duty of enforcement. But that is not a duty of a guarantor and it's not a duty of a fiduciary. Baird vs. Franklin and the Hochfelder case have said that.

Mrs. Murphy was wrong when she compared the stock exchange to the Federal Deposit Insurance Corporation. The law suggests that there is no analogy in that respect. We are not an insurance company.

The exchange has no duty to enforce until it knows of a violation. It must reasonably look for violations, but for those violations which it does not know or reasonably should have known, such as the debenture rollover, it's not charged with a breach of duty because the violations occurred.

The exchange, and this is most important, as I think we have all realized in this case, the exchange is accorded substantial discretion, flexibility and initiative in interpreting and applying its rules to obtain compliance. That's been said most recently in this circuit in the Gordon case, where Judge Kaufman noted that both the Senate and the House reports that led to the '34 Act stressed the broad responsibility left with the exchange to administer its own affairs. The Intercontinental Industries case in the Fifth Circuit, said that these are the rules of the exchange and it should be allowed broad discretion in the determination of their meaning and application.

Judge Lucas said in the Hughes case that sometimes the exchange has to choose between various alternatives. It has responsibility to many groups: customers, subordinated lenders, other brokers, the economy in general. And in going about attempting to

balance the duties that it owes to all these people, it must be accorded fundamental flexibilities and discretion.

You will recall in the Hughes case, the stock exchange did not suspend the firm of Dempsey Tegeler even though it had a capital deficiency of $20 million, it had a back office problem for ten months before Mr. Hughes put his money in. Rather, the exchange permitted the firm to follow a rational plan for its improvement in an attempt to overcome both its operational problems and its capital problems.

And in this district within the last year Judge Connor in the Williston and Beane case said that it's beyond speculation that he exchange must be given broad discretion in making the crucial determination as to the continued membership of a broker-dealer which would involve a grave hazard of financial injury to the exchange or to firms' creditors.

I think that case is very instructive, your Honor. If you will recall there, the exchange did suspend in 1964, in the panic which was the salad oil scandal, the firm of Ira Haupt & Company and the firm of Williston & Beane.

In Williston & Beane's suit against the

exchange they used terms like group boycott, violation of the antitrust laws. What they were saying is you didn't have good cause to suspend this firm. We are no Ira Haupt. We are over here doing our own little business. The exchange won that case and the suspension was upheld.

I think it important to note that while you may have a subordinated lender with hindsight saying you should have closed this firm down a little earlier, you will have somebody like Murray McDonnell saying you should have closed it down a lot later or never at all.

THE COURT: What was that last thing?

MR. BROOKS: You should have closed it down a lot later or never at all. That's what Mr. Beane told us in the Williston & Beane case. Judge Connor said that the exchange has a certain amount of discretion and flexibility.

Whether the exchange acted reasonably and in good faith is not to be judged from the hindsight of today but from the vantage point of those men who were on the hot seat in 1969 and 1970, who were called upon to make these regulatory decisions. The question we have to ask is whether they proceeded rationally and in good faith to fulfill their duty.

I think no reasonable man on the evidence in this case could say that they did not in respect to McDonnell & Company.

Let's just take a look at the period, your Honor. It was the period of the paperwork crunch, as Mr. McElroy has told us. All firms were trying to convert to more speedy data-keeping systems.

The paperwork problem affected the capital of the firms. It affected this computation of liquidity, which is called net capital under Rule 325, because the paperwork crunch was turningup concepts that exchange examiners had never seen before.

Stock record differences, dividend short receivable accounts, things of that nature. And these new facts called for judgments. Because the rule didn't speak to them. It's as if the farmer told his hired hand that you put the cows in one pasture and the horse in another and all of a sudden a unicorn came walking around. The hired hand didn't know what to do with the unicorn. He called the farmer back and said what do we do? The farmer said, I don't know, let's think about it. Let's try to draw some analogies and see where we are going to put the unicorn.

That's what was happening in '69 and '70 and

late'68. There were a lot of unicorns coming along. Nobody was quite sure what to do with them. Judgments had to be made and the exchange had to make them because it had the responsibility.

So we get such issues as, is a certain bulk of letter stock eligible for capital consideration or not?

Mr. McElroy told us that there was a procedure where it could be evaluated and some determinations made on the particular facts. And sometimes there could be some credit given for some lettered stock.

We have questions about income tax refunds, because the prior years had been very prosperous; 1969 and 1968 were showing some losses. Firms wanted capital credit forthose losses. They said the IRS is as good as gold. The stock exchange said maybe you won't get it. They said, oh, we will get it. So they had to arrive at a point of determination and decide whether they would get it or not.

Mr. Arning testified that the question of how to treat McDonnell's rights positions came up for a decision and he decided that since McDonnell was a unique firm, it was the rights specialist and there was no risk in these positions because there was an

offsetting entry, that they could be allowed capital credit.

There was the problem of stock record differences that nobody knew what to do with, whether it was just a matter of sorting things out or whether those securities really weren't there at all. There were judgments made. There were 25 per cents and 30 per cents and 50 per cents of value applied.

Now, these were judgments that had to be made. But I submit, your Honor, there is no evidence to show that they were not rationally made and that they were not made in good faith.

When the '67 audit of McDonnell came in, as Mr. Beebe pointed out itwas late. The capital was all right, but it showed some record-keeping problems. As a result the exchange restricted the firm in March. The firm made a very good response, as the letters show. Restrictions were removed a month later. They were told to be conservative and they were put on a special operations schedule of reporting so that we would get a report each month so we could monitor them.

Mr. Schuette testified that the problems were receding in 1968 until the end of the year, transcript 818.

The Lybrand audit was late. It had gotten two extensions. It was received by the exchange on about January 16th. The plaintiffs make a lot of this delay, but where does it lead? You have a capital problem, you have to correct it, and that's when the analysis should start, I suspect.

The exchange analysis was reported to McDonnell & Co. by Mr. Spies in his letter, which is Exhibit 74. It showed a violation over the 2000 maximum of 2717 per cent. Mr. Spies reported that the firm needed $500,000 of additional capital and for good measure it ought to get another $2 million so we don't have to worry about the firm again.

At a January 29th meeting Mr. Bishop laid down the law to the firm, that you fellows get in 500,000 by the end of the week, and this was the 29th and the end of the week was the 31st. You get that other two million in by February 20th. And on the 30th, McDonnell & Company came in with $950,000 of good capital.

Now, that's after the haircut, so we have 30 per cent more in market value. That came in from Anna McDonnell by a deposit in an already existing subordinated account, and Murray's wife Marjorie. You will

see that from Exhibit CC.

And by the 20th the firm had brought in that other $2 million. They brought it in by Mrs. Murphy's account, through some sales of voting stock, various others and by a subordinated account from an over $1 million trust which the trustees were Manufacturers Hanover Bank and Marjorie F. McDonnell.

It looked all right on the 20th, but the exchange, as it's obligated to do, took a look at the trust instrument and it said Manufacturers Hanover, a sophisticated trustee or not, we are not sure this instrument authorizes this kind of investment by the trust instrument. Take it out. You have to do that.

Now, thatwas essentially made up very quickly by Murray McDonnell going out and borrowing $600,000 from City Bank on March 10th. We see that in Exhibit EE1. Murray was to borrow a lot more later and put it into the firm.

By letter of January 28th the firm adopted a slew of self-imposed restrictions. I think it was pretty clear, I believe it was from Mr. Schuette's testimony, that self-imposed restrictions are volunteered by a member firm, who is fairly smart and fairly proud and knows what the exchange is going to do anyway, to say

we will do it ourself. You don't have to impose any restrictions. In any event, I think the question is under what program was the firm working? And they were working under these restrictions, self imposed or not.

I suppose the question becomes, should the -- the regulatory question becomes should the stock exchange have shut McDonnell down in January of 1969? Now, the plaintiffs have argued that they should in their answers to supplemental interrogatories, so I would like to meet that.

Here was a firm that had a net worth of $16 million, Exhibit AA. It had a willingness to adopt restrictions to clear up its paperwork problems, Exhibit BB1. It had a responsiveness to the capital problem from a seemingly inexhaustible supply of capital. Its problem was not too little business, but too much. It simply needed to slow down a little.

Plaintiff has produced no proof to show that McDonnell was not a highly profitable firm. Indeed a money tree, a money tree that had brought the McDonnell family to where it was in 1969.

Now, there are profit and loss statements attached to James McDonnell's claim to the liquidator, Exhibit 16, which nobody has quarreled with. They show

in 1965 the firm made a profit of $580,000. In '66, $705,000. In '67, $1,085,000. The first eight months of '68, $950,000. I'm sure those figures are profits after the salaries to James, to Morgan, to James F. McDonnell, III, interest on the subordinated debentures on the subordinated account on the preferred stock to the McDonnells at rates to which they were entitled as insiders under the exchange rules.

Rather than being something the exchange should have been would have been the height of irresponsible regulation to shut this firm down in '69. The capital rule doesn't authorize shutting a firm down because there is a violation of the capital rule. In fact, the capital rule says that the exchange can make an exception to the rule.

I don't contend that was made here, but I think it shows that this is not a go or no-go situation. The exchange article 14 of the constitution provides that there can be disciplinary proceedings brought to determine whether there has been a violation, and if so, what.

Article 13, section 2, provides for summary suspension of the firm. That's what happened to Williston & Beane, but you have to show insolvency or an inability

to continue in business with safety. And how can you show that when you have a $16 million net worth, a seemingly unlimited supply of additional capital, and a pattern of steadily increasing profits?

If this firm were suspended in January of 1969, your Honor, what's the alternative to those 50,000 customer accounts that are locked in a firm which is a going business one day and is out of business the next day? Where are the employees going to go who were working to clear up the paperwork problems that showed the status of those 50,000 customer accounts? Are they going to stay at McDonnell & Co. when they can go over to Bache and Merrill Lynch who paid six-week bonuses at the end of that year, in a labor-short market? No, sir. It would have been the height of irresponsibility in respect of the exchange's duty to the customers to take any action like that.

And let's try to posit what would have happened if the exchange would have shut this firm down in January '69 with the McDonnells. We wouldn't have had this lawsuit. There would have been another one. The complaint would have been signed by Tom Ford, Murray and his wife would have been plaintiffs, Morgan would have been a plaintiff, and McDonald Ford Johnson would

have been a plaintiff, and that McDonnell would have been a plaintiff for her already existed subordinated account, Sean's estate and the three trustees that are suing; the two trustees that were suing would be suing as well for the loss of their investment and for the loss of future opportunity which would have been astronomical. We would have had another Williston & Beane case. It would have been a loser.

The thrust of their claim was you chopped down a perfectly good money tree. The testimony would be from Murray and his wife that we could have put millions in this firm if you only gave us a day.

Murray would say, I could go across the street to City Bank and on my signature alone get you a million and a half or two million dollars. Mrs. McDonnell would have said, if I knew this firm needed money and I had a day I could go to my safe deposit box, come in with a million and a half of additional securities, and I would do it for a son and for the firm of McDonnell & Company.

Margaret Mary would have testified that I would have given my brother my account in a subordinated form if he had asked. I would have done him a favor.

James, the prudent trustee that he is, would

testify that the exchange acted in a most irresponsible way and if he had been given the chance he would have put a million of his own money in this firm. He would have talked to Mr. Chapin, Sanford Kaplan, Mr. Meehan, and they would have all helped. I'll bet we would even hear testimony that Henry Ford would have come in and gave some help if he had only been given the chance.

Now, throughout the case Mr.Beebe has asked exchange employees, well, you knew such and such about McDonnell & Company as a result of your inspection or as a result of this report or that report. Did you tell the public? The answer was no, we didn't tell the public.

Your Honor, they are not required to tell the public. No responsible regulator discloses the facts that it gathers in confidence from those that it regulates. If it did that they would get very little facts and it wouldn't be a good regulator.

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The SEC, the IRS, the FDIC don't make any disclosures that come to them in the course of their regulatory duties public information. Before the Freedom of Information Act, it was a tough job to get any information out of the SEC in 1969.

THE COURT: Do you want to take a break for a few minutes or do you want to go on?

MR. BROOKS: Maybe a five-minute break and a glass of water.

(Recess)

MR. BROOKS: Before the break I was talking about the argument that the exchange had a duty to disclose the financial operational facts it learns in its regulatory investigations to the public. We fought that fight in court before and we won it in the Investor Protective League v. New York Stock Exchange, a decision by Judge Lasker, and Rich v. New York Stock Exchange. I think both of those decisions are in accord with our proposition that it is irresponsible for a regulator to disclose pertinent operational facts that it learns from its regultees, so to speak, as a matter of public information.

Now, we have had a lot of testimony about knowledgeability letters. What does the evidence show as to that? It tells us there is this rule of the exchange

which requires them. It tells us that it was a practice of the exchange to require them on an ad hoc basis when it thought that the going of a particular firm was getting particularly tough. And I think from their face it is pretty clear that their purpose is to preclude lawsuits like this. We wished we had them in this case, but we don't.

Exhibit 56A was a letter sent to the firm of McDonnell & Company which asked that information be supplied on and after May 21st. That was the day in the exchange's judgment when they were or should have been required for McDonnell & Company, and I suggest there is no evidence to contradict that judgment or to show that it was not made in good faith or that it was not a reasonable judgment. There is also no evidence to show that these plaintiffs would have acted any differently if they had gotten that form and been asked to fill it out or sign it. It is certain that one of them would not have read it. Perhaps another one would not have read it or cared. And no plaintiff has testified that it would have changed his or her conduct in the least. The plaintiffs don't argue that McDonnell & Company should have shut down in January, as they argued in their answers to our interrogatories. I suppose they were left with arguing that between January and March of 1970 the exchange should have made some different judgments

about McDonnell. And I submit there is no evidence to show what those judgments should have been. There is no evidence to show that those judgments would have been more reasonable or how they would have helpad the plaintiffs. In short, I think it is pure speculation.

Mr. McElroy's reports in April show that there was some short fall in the capital ratio of McDonnell, but that is because the exchange hadkicked back the Manufacturers Hanover margin in McDonnell, and there were these other transactions, one with City Bank, which, of course, comes in cash, and avoids the haircut to essentially break that up. Mr. Schuette did say in early April, "I think you should put some restrictions on the firm." Fred Stock said, "Let's hold off a little on the restrictions; let's see if we can get them to come up with a workable plan and try to resolve these problems." It is a judgment. Who can say it is wrong? And then restrictions were put on on May 21st. Things didn't get any better. Up until Memorial Day this firm had shown an inexhaustible supply of additional capital. Only on Memorial Day did the exchange realize that maybe th well was not inexhaustible. Thereafter, Paul McDonald came in, a retrenchment plan started. Harry Lindh came in to take the place of Thomas McKay, who had died. The firm started to sell branch offices, to retrench, as shown

Exhibit 83. During the summer things were sort of touch and go. They were trying to convert from a major retail service firm to a smaller firm having its roots and business and position in New York. We have seen a press release in August, which is Exhibit T. I am not sure why the plaintiffs have talked about this press release, because nobody said they read it, except James. James said he knew it was not true. He said that at transcript page 404, but then he went on to back up a little. He said he really didn't know what the status of those negotiations were with the Lufkin group that were considering making an investment in the firm. The exchange had been told as late as August 20 in Exhibit 62, a memorandum, I believe, of a phone conversation between Mr. Lindh and Mr. Newman, that there were a few details of getting in this three to ten million dollars still to be worked out. It looked like it would still be coming in. There is no evidence to show that the press release was not a true report of the state of the negotiations on the day it was issued, and there is no evidence to show McDonnell & Company on its own did not put out a qualifying press release some time later. The exchange has no rule applicable to press releases; it does not have to approve them; it does not have to get them. I think the press release is a phony and prejudicial issue. That is the way

the plaintiff let it rest. The firm continued to look for new capital in August. James has testified about his valiant efforts to raise capital and get assistance from his influential friends -- pages 414 and 417. He was unsuccessful. They had a capital reorganization which was designed to eliminate the haircut on 8.8 million dollars, get in that additional 30 per cent, and improve the equity debt ratio of the firm. And it was in Exhibit 4, that September 30th letter which was signed by all of the family, which asked the exchange to lift the restrictions. The only facts that the plaintiffs have put in on regulation in late '69 and '70 is that language, that Newman knew the firm had been liquidated, but he did not know why or didn't know when. I think we do know that on March 13th the firm was liquidated. Throughout this regulatory saga that we have examined for two weeks, I suggest to your Honor that there has not been one piece of evidence to show the exchange was not proceeding reasonably and in good faith. I think it is confirmed by Exhibit 86, which Mr. Beebe put in on Friday, which is the exchange special membership bulletin, in which President Haack reported to the membership what the exchange had been doing during these last two very unusual years. I am surprised it was put in because Mr. Haack wrote this as a testament and tribute to the exchange's practice. I

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think I am entitled to read on this issue of reasonableness and good faith from that. It is Exhibit 86, your Honor, the report to the members of the exchange on self-regulation. I am going to read selectively, but it says, among other things, that the three-year period has been a period of perpetual crisis. The exchange has had to intervene at one time or another in the affairs of 196 member firms, on behalf of all the firms doing business with the public. These firms carried more than 2.2 million customer accounts and represented a combined aggregate indebtedness of more than $3.48 billion.

Significantly, of these 196 firms, only about 6 per cent, that is, 12 firms, have had to be suspended or liquidated by the exchange as of this date. Your Honor, that is 94 per cent that have not. That is a good grade. Today -- that is, October, 1970 -- no firm is under restriction due to paper work problems.

"As the paper work crunch eased, one of the severest financial squeezes in the industry's history began. The squeeze was caused by a decline in trading volume and sharply dropping prices which created severe operating losses and eroded the capital of member firms." That is why McDonnell was having such a difficult time making a go of it. The market had turned terribly against

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the brokerage industry after they had all geared up; they still had to pay for these systems that they had installed and they didn't have any income. Mr. Beebe called Mr. Arnie's attention to language at the top of page 2:

"A question often is asked why did the exchange allow a few major firms to continue in business despite critical paper work and capital problems." Now, I think that does not really forward the inquiry, because as Mr. Arnie pointed out, the problems are not the same as violations. It does not talk about when these problems existed, when the exchange might have acted in a different way. It could be those problems did not exist in McDonnell & Company in January of 1970 when Mr. Beebe talked about the change of attitude on the part of the stock exchange.

Your Honor, when you read further, it says: "This was the case, for example, in three major firms, Dempsey-Tegler & Co., Inc., McDonnell & Co., and Blair & Co., with a combined total of 165,000 customer accounts. In each case the exchange allowed continued operation under increased regulation, pending a scaling down of business and reduction of paper work backlogs to manageable operations.

"These were the key reasons for this approach.

"A. The severity of paper work problems in these firms and the great number of customer accounts involved would not

have allowed orderly liquidation had the firm been suspended. Errors in stock records alone would have required many months, perhaps years, to resolve.

"B. Suspension could have emptied these firms of clerical staff at a time of intense competition among brokerage firms for skilled operations employees. Demands of liquidation are great: For example, Pickard & Co., a small firm with 3,500 accounts suspended by the exchange in 1968, required 30 exchange examiners working more than 18 months ith the help of firm employees and auditors to resolve errors in records.

"C. Announcement of suspension of these major firms could have prompted a run by customers on firms which did not have a problem. With investor confidence shaken, the effect even on healthy firms might have been major. The chain effect of these events could have been grave."

Exhibit 86 goes on to say, "At one point or another during 1968 or 1969, a total of 105 firms had paper work problems that required restrictions on their business.

"As the paper work crunch abated, one of the most severe financial squeeze in the history of the industry began. In late 1969 and 1970, income from almost every phase

of the securities business was slashed amid steadily falling stock prices.

"Operating losses formed only a part of the picture. A sustained decline is stock prices, which dropped average values of New York Stock Exchange issues alone some 38 per cent from late 1968 to late May, 1970, eroded the net capital in firms and brought heavy losses in trading inventories. The combination of these financial blows, coming as firms were shaking off the paper work problem, was devastating.

"The policy of restrictions on the business of firms in operational trouble, begun in April, 1968, was unprecedented. There was a 'rifle' approach, with sanctions aimed at the individual problems of each firm. For example, in addition to the most common restrictions banning the hiring of salesmen and the opening of new branches, a St. Louis firm was made to suspend both underwriting and trading for its own account. While applying these restrictions, the exchange worked closely with the Securities and Exchange Commission, keeping the federal regulatory authorities frequently advised by letter, written reports, personal visits and telephone calls on the status of member firms.

Going to the matter of practical self-regulation,

"Practical self-regulation involves more than the development of techniques and enforcement of rules. In a crisis, such as the industry has experienced, the effect of actions must be weighed against the possibility of large-scale customer losses in problem firms as well as impact on other brokerage firms and their customers in the United States and abroad."

Exhibit 86 goes on to say, "For example, in the case of three major member organizations the exchange found itself facing situations where normal application of rules could have meant possible loss for many thousands of customers and potential chaos"--

I want to stop there and make a correction to Mr. Beebe's reading of the transcript on Friday, at page 1422, at line 10, where Mr. Beebe said "would" instead of "could," and it should read --

"where normal application of rules could have meant possible loss for many thousand of customers and potential chaos in the industry."

Then it goes on to identify three firms, Dempsey-Tegler & Co., Inc., McDonnell & Co., and Blair & Co. I suggest to you that this is not the capstone of Mr. Beebe's argument. It does not really tell us very much about the details but I suggest what it is saying is that if

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the exchange had given the usual 20 minutes that Duke Jones used to give in the mid-'60s, as Mr. Arnie testified, to correct the capital problem for a firm, that these firms would have been out of business, because 20 minutes would not have done it. That was not the practice in the late '60s; the practice was as it was applied to McDonnell & Company, as Mr. Arnie testified. The exchange used its rifle approach. The exhibit goes on to say, "The exchange allowed continued operation under increased regulation, pending a scaling down of business and reduction in paper work backlogs. The hope was a scaled-down firm would present a manageable liquidation situation."

Perfectly true. If any firm asked to be liquidated, it is much better to liquidate as a smaller firm than a larger firm. But there is nothing in this record to suggest the choices that were made with respect to McDonnell & Company to sell branches, to have a capital reorganization, when that choice is made by the management of McDonnell & Company and did not exhibit a very healthy will to live, and were it not for these problems, declining volume and plummeting stock market prices, I suspect the firm would have made it.

Now, our expert, Mr. Ratner, testified that the SEC had been directed by Congress to supervise exchanges

and to revoke their registration if they do not comply with their statutory mandate. That was at transcript page 1301. Mr. McElroy said the same thing earlier, at transcript page 719.

Section 19(a) of the Exchange Act provides that the SEC also has to coordinate power over exchange member firms. Here we have seen that the SEC itself maintained an extremely vigorous surveillance over McDonnell & Company.

In November, of 1968, and Mr. Beebe has put into evidence, there was an SEC operations check list for special operations report on McDonnell & Company. That is Exhibit 34A. They got that report that showed a capital violation. That is an audit report filed with the SEC as X-17-A-5. It is Exhibit Z, transcript page 718. Mr. McElroy said that as a matter of course, as a matter of SEC rules, that goes to the SEC.

Then on February 10, 1969, there was Mr. Schuette's memorandum. Mr. Schuette is on the phone with the SEC talking about the findings after reviewing McDonnell & Company. It is Exhibit CC(1).

The examiners of the SEC were at the firm April 30, 1969. They talked to Mr. Schuette about it. That is Exhibit SS.

Thereafter, in essence, the SEC got the same

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reporting from the firm of McDonnell as the exchange got. We put in with Mr. Newman Exhibits UU to HHH, the reports on the firm of McDonnell & Company from April until November, 1969, a copy to Fred Stock, usually a carbon copy to Hank Newman, a carbon copy to the SEC. I think the fair conclusion that a reasonable man would have to make is that the SEC knew the facts, knew what the exchange was doing, and they did not intervene.

Under such cases as Exchange Buffet v. New York Stock Exchange, Crimmins v. American Stock Exchange, and Securities and Exchange Commission v. Sorg, a victory by Mr. Beebe's firm, and a presumption that the conduct of the exchange in McDonnell conformed to the requirements of the Exchange Act.

Now we saw the trust fund come into the picture on Friday afternoon. I suppose the argument that the plaintiffs will seek to make is that in Mr. Beebe's joust with Mr. Arning, at pages 1406 to 1414 of the transcript, about the trust fund was that its existence motivated the exchange to neglect its duty in respect to McDonnell. Well, that is not possible. First, the deed of trust fund, Exhibit III provides in paragraph First that its use is in the sole discretion of the trustees, and in paragraph Fifth, no one has any vested right or any claim for either action

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or failure to act by trustees. There was no commitment to help anyone. They did help. Your Honor, I think that is only testimony to their responsibility, and it is something that you will find in no other sector of private industry, where a group of competitors get together, get up some money to help customers of another competitor.

I don't think it should be held against the exchange because it did that. Certainly it cannot be held against the exchange on the basis of fearing of claims when claims were not possible. There can only be voluntary beneficence.

There is no evidence, furthermore, of any regulatory decision being made in respect to McDonnell having been influenced by the existence of the trust fund. All of these memoranda that came in, all of the testimony from five, six or seven exchange employees, not one word about anybody doing anything because of the trust fund or because of the lack of the trust fund. Mr. ARning flatly denied that any decision in respect to McDonnell was influenced by the trust fund.

And if that isn't enough, your Honor, I suggest that the rejection of that $1 million from Manufacturers Hanover Trust Company ought to really nail it down. You don't throw a million dollars back if you are trying to save yourself some money.

Your Honor, I come to the last "even if" argument. I think if there was any argument that is as clearcut as this one, I haven't seen it. And that argument is that when you make a claim for failure to fulfill a duty under Section 6, even let's assume

that you establish that claim you have to go another step. You have to show that the breach of duty injured your plaintiffs. Because we are not, as Mr. Ratner wanted to talk about, conducting a legislative inquiry. You must show in this lawsuit thqa the breach of duty, if you can establish it, proximately injured the plaintiffs. We know that because this circuit is where it all started in Baird v. Franklin.

The Court, in Baird v. Franklin, did find that the exchange breached a duty. A former precedent of the exchange was embezzling money. The exchange knew about it; didn't do anything. But there was no liability found against the exchange in Baird v. Franklin because there was no proximate cause, and there is no proximate cause in this case, your Honor.

This principle has been articulated in almost all the cases that came after the Baird v. Franklin. In the Seventh Circuit, Butterman v. Walston. In this district a year ago or so, Judge Gagliardi's decision in Marbury v. Kohn.

I think I would have to concede if the plaintiffs could show that any reasonable man could say the exchange should have shut this firm down on January 27, then as to the claims of Anna McDonnell for her January

30th deposit and the claims of Margaret for her February 4th deposit, and the claims of James for his April purchase would be proximately connected to the exchange failure to shut down McDonnell on January 27th. Because McDonnell wouldn't have been there on January 30th and they couldn't have put their money in.

But no reasonable man could so conclude that the exchange should have shut McDonnell down on January 27th. I think I have submitted ample argument for that.

If they can't show that the exchange should have shut the firm down before they put their money in, they have to show the exchange should have done something differently. They have to show what it should have done differently, and they have to show that doing it differently would have helped them financially, made their stake in McDonnell & Company any better off.

Your Honor, there is no evidence in this record on any of those propositions, no evidence whatsoever. The evidence is the other way. James testified that in August they talked to the lawyers of Ira Haupt & Company. That was the best and last prior experience of such an episode. Those lawyers told them in essence, my God, don't shut this firm down now. You

capital contributors will be wiped out. They convinced everybody who had any money in the firm. They didn't convince James. I can't explain why not.

Anne McDonnell Ford Johnson was convinced, Anna McDonnell was convinced. Everybody was convinced that they had their dollar at risk.

I suggest,your Honor, that shutting this firm down at any time prior to March 13th would have, as those Ira Haupt lawyers said, would have worsened, worsened the situation of the capital contributors because you would have shut down a firm with 50,000 accounts which the capital contributor's money would have had to get out of the firm because those customers were all creditors. You would have 26 long-term leases throughout the country, one in Paris, running ten, fifteen years, on a beautiful office and the landlord would say that you are in default, 26 years rent. Pay up, Mrs. Murphy, pay up, Mrs. McDonnell.

I suggest,your Honor, that you just can't show, once they are in --

THE COURT: Mr. Brooks, isn't the answer going to come back that a bankruptcy in August of '69 is no different than one in March '70?

MR. BROOKS: I don't know how that helps

them. They were told by the Haupt lawyers that you can't do it now because you will at least come out zero, you will lose everything. What I am saying is that would be true at any time after they put their money in, or at least they haven't shown to the contrary and the inference is that it would have been true because their capital would have simply been at the risk of a bigger business, shut down a bigger business and you have a bigger job to do to satisfy the claims of the creditors to getthem out.

If they are taking a middle position that, well, let's not talk about shutting down, let's talk about a few more restrictions here, a few less over there, let's talk about this technique or that technique. There has been no evidence of any of those techniques, there has been no evidence as to how those techniques would have made the situation better for these plaintiffs. And that's their burden. That's one of the elements in their case. Baird v. Franklin told us that back in the early '40s.

THE COURT: What you are saying to me then, if I understand you on this point, is that anything really beyond August is irrelevant in effect.

MR. BROOKS: I think anything beyond April.

THE COURT: Certainly beyond August where the Ira Haupt lawyers had said to the management, don't shut it down.

MR. BROOKS: Yes.

THE COURT: Because you will be wiped out and therefore they only have one place to go and that's up from that point.

MR. BROOKS: Yes. If you took a look at the statistics in Exhibit 86, which is the stock exchange membership bulletin, those facts, employee shortages in the industry, customer accounts that have paperwork problems behind them, where you have to spend some time and expense to sort them out, and saving once their money is in the firm, if you are talking about closing the firm down you are talking about wiping out the capital contributors.

If you are talking about something in the middle, one technique here, one technique there --

THE COURT: I'm keeping in mind your position that the claim is that the exchange should have done something. The undisputed state of the record at this point is that starting in August, the time of the meeting with the Haupt lawyers, McDonnell & Company would have not wanted the exchange to do anything

except keep them going. So there can be no claim of anything the exchange didafter August. Then you only get down to is there an issue that should go to the jury on anything that happened before August.

MR. BROOKS: Yes. On the question of proximate cause I say the plaintiffs have raised no issue by any evidence.

THE COURT: Mr. Beebe will address himself to that in his good time, I'm sure. I will giveyou some rebuttal time here when you hear what it is.

MR. BEEBE: May I make a suggestion, that if there is some way to contact the jurors, that they be advised that this afternoon's session may be collated or perhaps not even held because I have a good deal of rebuttal?

(Discussion off the record)

THE COURT: Good suggestion. We will set about it.

MR. BROOKS: Your Honor, with plaintiffs Anna McDonnell and Margaret Murphy, I think there is what there is called in law, and has been called for a long time, a supervening proximate cause. That is, that under their agreements, Exhibit B1 and Plaintiffs' Exhibit 3, paragraph 1A, they always had the option of giving

notice 100 days and pulling out their money. Now either they didn't read the agreement or they read it and didn't want to do anything.

If they had that opportunity, they could have walked away from this with their money. And that is a different story, as Mr. Beebe has elicited testimony about, withdrawing securities from an existing subordinated account. That's talked about in some other place in these agreements. I am talking about terminating an existing agreement under paragraph 1A of each of these agreements they could have done that in a hundred days and walked away. They never did it. I consider that a supervening proximate cause under ordinary tort law principles, and that everything else aside on this question of proximate cause should absolve the exchange on its regulatory conduct, if there could be shown any impropriety in that conduct.

The same is true of the debenture, as I have argued before. If you look at the debenture as a regulatory claim rather than a fraud claim, I think it's clear there was knowledge about this exchange admittedly by James, as early as June. I think we can show on February 25th.

There was still the same forebearance when

there was aright to pull out the money. In the face of that forebearance they have lost the element of proximate cause which they must show to make the regulatory claim under Baird v. Franklin.

I am about finished, your Honor. The bottom line comes down to the fact that the plaintiffs have not put in sufficient evidence on which reasonable men could find against the exchange under the applicable law.

I submit if this case went to the jury on this record, even if the jury were to find for the plaintiffs, your Honor, as a matter of law, would have to enter a judgment notwithstanding the verdict for the exchange.

That being the case I argue that it should be done now to save the parties, the jury and the Court the expense and the wear and tear of another week of trial and to let my Mr. Bishop get back to regulating his member firms.

The case against the exchange, your Honor, simply comes down to a claim for insurance for a bad investment and not a cause of action at law.

Thank you for hearing me for so long.

THE COURT: Mr. Beebe, do you suppose I should hear from all the movants and let you respond?

MR. BEEBE: Yes, sir.

THE COURT: I think that would probably be best.

Mr. Loflin, if I may call on you at this point, please.

MR. LOFLIN: Very well, your Honor.

May it please the Court, I have heard Mr. Brooks's argument and of course much of what he said would apply to the American Stock Exchange as well. I will not repeat that argument but I do endorse it, and in order to limit time I will content myself with that, and address myself to those matters which I consider are uniquely applicable to my client, the American Stock Exchange.

The Court, of course, is well aware that we took very little testimony as the plaintiffs' case unfolded. I asked a couple of questions of each of the plaintiffs, Margaret Mary, Anna who testified here by deposition, and James, were all asked if they had any contact with any representative of the American Stock Exchange before or after their investment that is in issue in this case. All answered they had no such contact.

James, of course, who was here in court, I

examined in a little more detail for reasons that I am sure are apparent to the Court. You will recall thatin the spring of 1969 following the request of his brother Morgan, James decided to become the manager of the Detroit office of McDonnell & Company, and in order to prepare himself to exercise that responsibility he came on to New York and took special training. He also was required to become a voting stockholder and an allied member of the New York Stock Exchange and the American Stock Exchange.

In the course of preparing himself for allied membership he studied the rules of the exchanges and their conclusions. This was definitely required because he had to represent to these organizations as a condition of his membership that he was familiar with their rules and constitutions, and more importantly still, he would abide by them.

James testified that he had gone through that routine, he had attended this course, he had studied the rules and he intended that these exchanges rely on the statement he made in his application.

Now, I have to conclude, as James intended for my client to conclude, that he was familiar with our rules as of that time. And our rules provided then,

as they do now, that whenyou have dual member firms, firms that belong to both the Amex and the New York Stock Exchange, basic financial oversight described at such length in this record would be exercised by the New York Stock Exchange and not by the Amex.

James had no illusions on that score. The securities community and all lawyers who advise them know about that. The Securities and Exchange Commission has known about this since its inception and so has the Congress of the United States.

Now, in this connection I would like to refer briefly to the testimony of Professor Ratner who attended here and testified very briefly. At page 1300 of the record he made a very succinct statement concerning the relationship between the exchange and the SEC. I'm quoting from Professor Ratner:

"What they did is they said we will leave the exchanges in the position of regulating their members, but we will require every exchange on which business is conducted to register with the SEC. In order to register it will have to file its rules with the SEC and those rules must be satisfactory to the SEC in terms of promoting just and equitable principles of trade."

It goes on to refer to the agreement.

As a condition of being allowed to function as a national securities exchange the American Stock Exchange and the New York Stock Exchange in 1934 filed those rules and we would not have gone into business under the '34 Act and we would not be in business today had the SEC foundthose rules objectionable.

Now, why shouldn't the Amex or Midwest or Pacific or anyone of the other exchanges be in there with their auditors every few months checking up on member firms? Well, there are reasons of practicality and just sound business sense that underlie this. We learned from Exhibit Z the full roster of exchanges that McDonnell & Company belong to in addition to New York.

It includes, of course, the American Stock Exchange, Boston Stock Exchange, Pacific Coast, Detroit, Midwest, Honolulu and the Philadelphia-Baltimore-Washington Exchanges. That was the mailing list of exchanges that got copies of the Lybrand, Ross Brothers now famous audit as of October 1968.

There was one witness called from the American STock Exchange, Mr. Vernon Lee, who was formerly secretary and a vice president of the exchange. While

Mr. Lee was on the stand Mr. Beebe offered some correspondence indicating that in fact the American Stock Exchange had gotten a copy of this report and they were advised by McDonnell & Company they were going to get it, and in one short sentence Mr. Thomas McKay said the following:

"We are informed by our auditors, Lybrand, Ross Brothers and Montgomery, that as a result of our annual audit as of October 31, 1968, we are under capital requirements as computed in accordance with Rule 325 of the New York Stock Exchange."

Leaving out a sentence he goes on to say, "We have already reported this fact to the New York Stock Exchange and are meeting with them next week at their convenience to discuss this matter."

Mr. Beebe went on to ask Mr. Lee what the American Stock Exchange did upon learing that there was a net capital problem for McDonnell & Company as indicated in this letter. Mr. Lee said that we didn't take any specific action on that. Of course they didn't take any specific action on that. Their rules clearly state that such matters are in the hands of the New York Stock Exchange and McDonnell & Company's own information furnished to the American Stock Exchange was to the

effect that they had advised New York and were about to meet with them on this very problem.

There would have been no surprises to anyone familiar with the industry that the American Stock Exchange would not have acted to leap into their business and make their own investigation and put a new layer of regulation and activity on them. There have been times, and there will be times again, I'm sure, when the Amex does not agree with the New York Stock Exchange. To say that each and every person who looks at the complex of facts that you would have found in McDonnell & Company from January 1969 until the spring of 1970 would either agree on what the facts were, much less the remedies, I think is asking a great deal.

And the Securities and Exchange Commission, which, after all, as Mr. Brooks points out, does have a pervasive influence and control over what the exchanges do and what the member firms do, has long since been familiar with who is going to do the regulating of which firms. The Amex is expected to regulate firms that solely belong to Amex. It's not expected to regulate firms that also belong to the New York Stock Exchange as to the matters that are at issue in this case.

Now, I would like to refer briefly to public

evidence of this understanding on the part of the SEC. I am referring in part to a memorandum of law that we served in support of our motion to summary judgment and this document did go to the plaintiffs' counsel.

MR. BEEBE: Excuse me, is this evidence in this case? I have some public things I would like to read too, but I don't think that comes in as something to be referred to unless it's in evidence already in the case.

MR. LOFLIN: For this purpose, I believe, on a question of law, and I am arguing as a matter of law this matter should be dismissed, I think this testimony to Contress, and I am also going to refer to a report of a special study, Mr. Beebe, and I am also going to refer subsequently to a statute, any one of which I think the Court could take judicial notice of.

MR. BEEBE: I have no objection to the statute.

THE COURT: Is this printed in CFR?

MR. LOFLIN: I believe the report would have been but I don't believe the actual testimony. The testimony to which I refer is the testimony of the former chairman of the SEC before a Congressional committee.

THE COURT: This is something I could look at as being legislative history.

MR. LOFLIN: No question about that.

THE COURT: The statute will rule as a matter of law.

MR. BEEBE: The statute I have no objection to. If it's Congressional testimony I have such things I would like to allude to which are printed in public documents. As the state of the record is right now, they are not in evidence yet.

THE COURT: Mr. Beebe, it seems to me something that throws some light on the statute o the rule, in the nature of its interpretation or otherwise, lawyers are arguing legislative history all the time before the Congress.

MR. BEEBE: Is this prior ot the statute, sir?

THE COURT: I don't know. Let's see what happens here. I don't see any great evil is going to be worked by getting into this a little bit.

Go ahead.

MR. LOFLIN: In a statement to the House subcommittee on commerce and finance in November 1971, former SEC chairman William J. Casey stated the following:

"All broker-dealers are of course under the direct supervision of the SEC. Many are also under the jurisdication of more than one self regulatory agency. It has long been recognized that this situation could result in an unnecessary and burdensome duplication of regulatory activities. Consequently, over the years efforts have been made to avoid this duplication by allocating regulatory responsibilities among the various agencies involved. In our opinion this allocation of responsibility has on the whole worked successfully."

I won't read the balance of it but it's cited as HR Report No. 92-37B, 92nd Congress, First Session, pages 171-3.

There is a study, called a special study of the securities market, printed as HR Document No. 95 of the 88th Congress. This is dated 1963. It also addresses itself to this situation. I'll read in part from that study. It says:

"For the firm of multiple memberships, any unnecessary duplication of regulation or lack of coordination in regulatory efforts produces added cost and burdens that should be avoided to the extent possible."

The citation is 4 special study at pages 728, 729.

Finally, this approach to regulation, that is with an avoidance to practicalities, avoidance of duplication, was reflected in the Security Investors Protection Act of 1970. In section 9F of that statute you will find the following --

MR. BEEBE: Excuse me, that is beyond the time frame that's involved here. I object to bringing in testimony. Mr. Casey isn't here. I can't cross-examine him.

THE COURT: He is just giving me views of others and I have to make a determination as a matter of law on what's before me. This is in the nature of argument and I will accept it as such.

MR. BEEBE: Very well, sir.

THE COURT: What he is saying obviously arises when the Honolulu Stock Exchange comes in here and counsel has named them as a defendant, in theory.

MR. BEEBE: I appreciate that. I just don't see anything added by citing some person who is kind of bootstrapped in here to add weight, because it's Mr. Casey from the commission being quoted from some study that isn't in evidence. I'm not objecting to the

argument. It's persuasive or it's not.

THE COURT: I'm listening merely as argument.

MR. LOFLIN: That's what it's being offered for. We have rules and statutes and I'm hopeful this will be helpful to the Court in interpretation.

My final reference in this particular line is to section 9F of what is called the specific legislation, security investor protection act. It simply says this:

"In the case of a broker or dealer who is a member of more than one self regulatory organization, the commission to the extent practical shall avoid requiring suplication of examinations, inspections and reports."

To me this represents a policy decision on the part of the Congress recognizing the potential for duplications and a policy determination that those duplications are not desirable and they direct the SEC and the commission to avoid them wherever practical.

It's in this context that the Amex role I think has to be evaluated. The evidence does not show that the Amex was apprised of the day to day developments of McDonnell & Company.

Far from it. The evidence does not disclose that the Amex took any part in trying to devise a formula to stabilize McDonnell & Company, to help it out of its financial difficulties, to take any role in analyzing its capital position, in making any demands on McDonnell & Company to get its capital up to any particular level upon pain of being suspended or upon pain of any sanctions at all. There was activity that was described by competent people that the exchange took, and there was a great deal of activity. It was handled as it was understood that it would be handled by the New York Stock Exchange. It just seems to us as a regulatory agency which in this instance under its own rules as understood and approved by the SEC, that we were not required to regulate it, that we should not here be taxed for a very substantial sum in any damages for failing to do what its own rules said it did not have to do.

Now, insofar as the American Stock Exchange is concerned, that is all this case is about, and that is why I have not participated to any great extent. I have no case to show what we did when, in fact, we were not doing anything. The plaintiffs have known for months and months what the non-role, if I may, of the Amex was. I think we have here purely a question of law for the Court as to

whether we did anything we should not have done or failed to do something we should have done.

I would say in the first place among the things that an exchange is expected to do is to follow its own rules. Those rules are, as James McDonnell testified, readily available. He had copies in his own office in Detroit. He from time to time would refer to them. He had executed them before he took on as a branch manager; he came to New York and day by day learned more about McDonnell & Company. It is quite clear from his testimony he became more and more concerned. He consulted with his mother, I think, for whom he had clearly the greatest and most intense concern. He tried to caution her, to help her in any way he could. He consulted with his co-plaintiff in the case, his sister. He did what you would expect them to do, he was a sophisticated, successful businessman who when exposed to the facts could see their significance, and he saw the significance for himself and for his mother and for his sister. He wanted to help them any way he could. It didn't occur to him, or, if it did, he did not act on it, to pick up the telephone and say, "American Stock Exchange, I want you to put this company out of business," or regulate them or do anything. He never called us, he never made any complaint, never asked us to do anything. He

never assumed that he had any opportunities in those directions as a responsible man.

I think in light of the gravity of the situation if he thought that the American Stock Exchange had any role to play and we were not doing it, I would have expected a complaint. We got none. James McDonnell knew what was going on. James McDonnell had one insufferable difficulty: he was a McDonnell. Was he alone going to be the man to drop the guillotine on this family firm?

By the fall of 1969 he was apparently advocating within the firm that it go out of business. Others in the firm disagreed with him. He never came to my client and said, "I have a disagreement over here at the firm and I really feel they ought to be put out of business. Why don't you come down and do it." He didn't speak to us or ask us to do anything of the sort. He did not feel we were required to take that role. I can't pretend Mrs. Murphy knew that, unless he told her. But I know that James knew that. He is sitting there aware of the facts and engaged in some sort of intense debate with the other managers as to what the firm should do and disagreed with them. In hindsight he comes to this court and says, "I have been right for months and it would have been better somehow or other if they had entered into a kind of liquidation

and shut down when I said they should have in the fall or summer of '69, but you, American Stock Exchange, were not there when I needed you and I just would like you to send us a check for whatever we lost." Regardless of the statutory framework, that is just unfair. If we are talking about equities here and fraud and about responsible people being misled, if, in fact, they were misled, I suggest that they are reaching into an area of the law that the law will not permit them to reach into and beyond that elemental equity will not permit people who made these kinds of investments in a family firm to go out to a third party remote from the scene with hindsight, with a bare thread of legal theory and say, "We now have lost our money; we are not going to sue our brother Murray for the money; we would like you to pay it. You are not of the McDonnell family, you are a stock exchange. Maybe you got the money we lost. You pay us now." That is unfair. This court should not countenance that. I say there is no question for the jury; there are no disputed facts to go before the jury. The rules have not changed in mid-stream. The interpretation of rules are not obscure. The SEC understands them, the Congress understands them, the industry understands them. One of the plaintiffs says he understands them. He knew what he was getting into, he knew the New

York Stock Exchange was making investigation, making plans, issuing edicts, regulating McDonnel & Company for the protection of the investors. And to come in here years after the fact and say to the American Stock Exchange, "You should have been doing this or that," there is no basis for that, your Honor, and I ask the case be dismissed as to the American Stock Exchange.

MR. STEIN: Your Honor, I will try to limit my remarks in view of Mr. Brooks' very thorough presentation.

If your Honor please, as counsel for the receiver of McDonnell & Company, I join with and hereby move under Rule 50 for a directed verdict at the conclusion of the evidence offered by plaintiffs. The principal thrust of our motion is that the plaintiffs in this case have failed to satisfy their burden of proof by showing by a preponderance of the evidence that McDonnell & Company violated Section 10(b)(5) of the 1934 Act and the rules promulgated thereunder.

Mr. Brocks spoke at great length about the disclosure aspects of the case and also about the regulatory aspects of the case. I will confine my comments to supplementing those of Mr. Brooks only with respect to the disclosure case, because the claims that are made under Section 6, although they are purported to be alleged in

their complaint against McDonnell & Company or against the receiver of McDonnell & Company under the statute, the receiver of McDonnell & Company has no duty whatsoever to these plaintiffs, and I will not speak as to that.

Before I discuss the five specific claims that are noted on the chart across the room, I think it might be helpful to discuss very briefly the elements of the 10(b)(5) case and then make some other comments that I have and buttress some of the comments that Mr. Brooks made, particularly in the area of due care. We know that in order to make out a claim under 10(b)(5), a claim for misrepresentation, we need a statement of an untrue fact. The fact has to be material. The plaintiff has to exercise due care. There is an element of reliance and there is an element of scienter.

I would like to discuss the due care aspect, or, more precisely, the lack of due care that as a matter of law defeat some of the claims in this case. Let us analyze the claim of Margaret Mary McDonnell Murphy, whom I will refer to as Mrs. Murphy. Mrs. Murphy's claim is for approximately $400,000. As to that claim, your Honor, I believe that the uncontroverted evidence has shown that plaintiff Margaret Mary McDonnell Murphy failed to act as a reasonable investor would have acted under all the

circumstances as they then existed. Mrs. Murphy testified that the principal alleged misconduct on the part of her brother Murray and/or his representative, Rick Olney, was to induce her to subordinate the securities in her account at McDonnell & Company, that she was told that there were no risks involved in subordinating such securities. We have her testimony at page 36 of the trial transcript. Her testimony was that following these statements, she signed the subordination agreement which she did not first read. Had she read the subordination agreement, she would have learned that she had agreed to subordinate her claims to those of "all other present and future creditors" of McDonnell & Company. By failing to read the subordination agreement prior to signing it, Mrs. Murphy, as a matter of law, failed to exercise ordinary care, because a simple reading of the document would have informed her of the risks involved in subordinating her account at McDonnell & Company. The subordination agreement specifically outlining the attendant risks was not only made available to her, but was signed by her. Yet she failed to ask questions that a reasonable person would have asked under the circumstances.

It is the law in New York, which is not inconsistent with the reasonable investor rule under the federal securities laws, that if the facts represented are not matters peculiarly

within the party's knowledge, and the other party has the means available to him of knowing by the exercise of ordinary intelligence the truth of the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.

This is a statement by Judge Breitel, then an Appellate Division justice in the case of Sylvester v. Barnstein, 283 Appellate Division, 333. It was affirmed by the Court of Appeals, 307 New York 778.

Now, I submit that that standard that I have just enunciated is instructive in this case. And it is the receivor's position here, your Honor, that as a result of her conduct, which is absolutely incontrovertible, she did not read that document, but she signed it, and in doing so Mrs. Murphy fails to meet her burden of proof of showing that she satisfied her duty of due care and is therefore barred from recovery herein.

THE COURT: Mr. Stein, do you think if she had read that subordination agreement from one end to the other all morning she would have known any better what she was doing? Suppose she read that and even were able to figure out that she was low man on the totem pole, at some point she might have said, "This is the way lawyers do these things

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and this is the way I have to put this money in on this underwriting." Do you think that this would have told her that this was risky?

MR. STEIN: The words, your Honor, speak for themselves. First of all, the document exhibit is entitled Subordination Agreement.

THE COURT: Then I get down to the ultimate question: Isn't this a jury question?

MR. STEIN: The analogy here is as between negligence and gross negligence. There are cases in the automobile liability field where the court does not not give questions involving due care to a jury because as a matter of law the plaintiff in the case contributed to the accident, or a defendant acted so negligently as to remove the question from the jury. It is not a question of fact any more. I am now talking about her failure to read that agreement, and I submit that this is the kind of case where we have that situation, such as where at a grade crossing you could be so negligent that the court does not give the case to the jury, that the plaintiff does not get to the jury on the issue of negligence or liability. That is what I am addressing myself to here.

THE COURT: I am sort of troubled with that. I have a feeling that the sister was told by her brother directly

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or indirectly there is no risk, and then a legal instrument comes over, and even if she read it it would not have said anything to her about risk, it would merely have said what her position was as an investor. I think on this record it is for the jury to pass on these issues. But let me give consideration to that. Go ahead.

MR. STEIN: There is one other separate and distinct ground. Mr. Brooks got into that to some extent.

Another ground on which Mrs. Murphy's claim should be dismissed as a matter of law is that she failed to show by a preponderance of the evidence that she would have acted differently had the alleged non-disclosures not occurred.

In order to recover on her claim, Mrs. Murphy would have to have shown that she, as a reasonable investor would have acted differently had the alleged non-disclosures not occurred. However, the uncontroverted evidence has shown that Mrs. Murphy attached no importance to the alleged omissions and would not have acted differently had they not occurred.

Thus, Mrs. Murphy testified that she learned in early spring, the end of April or early May of 1969, page 105 of the transcript, from her sister-in-law, Sandra McDonnell, that McDonnell & Co. was in bad financial condition

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She also testified that she did not take any steps to terminate her subordination agreement after acquiring this information, and that is at page 107 of the record. Instead, she entered into new arrangements in September and October of 1969 whereby she received a debenture and preferred shares of McDonnell & Co., stock in exchange for the securities which were in her account at McDonnell & Co., and that is at pages 109 and 110 of the testimony. It is incontrovertible from late April-early May to September 30th, the date of the recapitalization agreement, more than 100 days passed --

THE COURT: I don't disagree with you, but this has burden on credibility only.

MR. STEIN: Let me go beyond that, because I am trying to show that when she became aware of the information that she claims that she should have had, what did she do? She entered into a brand new deal. First she did nothing, and then she signed up again.

THE COURT: All I am saying is that the jury may conclude you are a hundred per cent right on that and that she would have given this anyway and throw her case out. But I think that is for the jury to decide, and not for me.

MR. STEIN: Maybe I am not making myself clear.

The contention I am making is that she failed to meet her burden of showing she would have acted differently, under the cases that are cited, the Titan case. There is a burden to show that the allegedly defrauded plaintiff would have acted differently had the non-disclosure not occurred. That is the standard she has to meet, that she would have acted differently. The fact is when she learned that which was not disclosed to her, she did not act differently. That is my point.

THE COURT: Give me that case, just the citation.

MR. STEIN: Titan v. Faggen. It is a CCH citation.

THE COURT: Are you saying that she has got to say some words, such as, "If I had known I would not have done it?" Does the record have to contain that in substance?

MR. STEIN: That may be a question of credibility. I think your Honor has to take all the evidence, and this is a burden she has got to sustain from all the evidence: would she, in fact, have acted differently when she had the opportunity to?

THE COURT: Because, as I asked Mr. Brooks, I think, in essence, whether it was not sufficient to show, in fact, to make it a jury question, that she would not. She asked Rick the question, "Is there any risk?" Doesn't that make it

a jury question?

MR. STEIN: I am talking about the alleged omissions, would she have acted differently, and what Sandra McDonnell told her two or three months later.

THE COURT: I think I understand you.

MR. STEIN: I would like to go to the claim of James F. McDonnell, Jr. in his individual capacity, for $20,718, which is number 4 on the chart. The evidence has shown that James F. McDonnell, Jr. failed to act as a reasonable investor would have acted under all the circumstances as they then existed, since at the time he made his investment, he had, at the very least, access to the statement of financial condition of McDonnell & Co., New York Stock Exchange Exhibit 16, which disclose that McDonnell & Co. had recently obtained infusion of capital in order to comply with the New York Stock Exchange rules concerning net capital ratios of member firms. That is at page 458 of the transcript.

I am now talking about the same negligence standard. The information was put before James McDonnell on a silver plate. The evidence shows that James McDonnell is as sophisticated a person as one ordinarily meets in business refinements. Despite his possession of the financial statement, or, at the very least, his access to it,

he failed to ask any of the questions that a reasonable investor would have asked or should have asked under the circumstances, and as a result of his inaction, James McDonnell failed to satisfy his duty of due care and is, therefore, barred from recovery herein. I submit that in failing to conduct any investigation after having read or having had access to the financial statement, he did not as a matter of law, satisfy his duty of due care, and a motion for a directed verdict as to his claim in this case is clearly warranted.

THE COURT: What you are saying is if he had read or appreciated the statement in the very first note, that the corporation currently meets the exchange capital requirements, he was on notice that there was a recent period in which it could not.

MR. STEIN: Yes, that is correct.

I think Mr. Brooks brought out during his motion on the argument on unauthorized consent, this is on the rule over the debenture, which would be, I believe, the third claim on the chart, it is the receiver's position that there was a failure on the part of these fiduciary plaintiffs to meet their burden of proving that the consent of the requisite number of trustees to substitute the Series E bonds for the Series B bonds was never given. Thus,

according to the trust instrument, page 16, two of the three trustees could make decisions that could bind the trust. It is undisputed that one trustee, Murray McDonnell, consented to the renewal.

The contention is made that James McDonnell, Jr. never authorized, acquiesced in or ratified the substitution, despite the fact that he did not challenge the transaction until more than nine months after the maturity date. Whether or not he was telling the truth I want to acknowledge is a jury question.

The third trustee, Anna McDonnell, has testified not only that she doesn't remember whether Murray McDonnell ever advised her that he was attempting to substitute the Series B bonds for the Series E bonds, but in addition she testified that she cannot even state with certain that the trustees never authorized the substitution.

I, therefore, submit that since the claim of James F. McDonnell, Jr. and Anna M. McDonnell on behalf of the trust is that neither authorized the transaction in question and since one of these trustees, Anna M. McDonnell cannot unequivocally deny that the trustees did, in fact, authorize the transaction in question, that as a matter of law, plaintiff Anna M. McDonnell and James F. McDonnell, Jr., as trustees have failed to meet their burden of proving

lack of consent, and a motion for a directed verdict as to their claims as trustees is clearly warranted.

As to the claim of Anna M. McDonnell in her individual capacity, the uncontroverted evidence has shown that plaintiff Anna M. McDonnell failed to act as a reasonable investor would have acted under all the circumstances as they then existed. Thus, Mrs. McDonnell testified that at the time she contributed and subordinated 1.4 million in 1969, that she was aware that the condition of the company was worse in 1969 than had existed in 1965 or 1962, that she knew that this worsened condition was the reason her additional capital was needed, and that she was aware of the risk that she might lose all her money. Yet despite all of this she failed to ask questions that a reasonable person would have asked under the circumstances. As a result of such inaction, plaintiff Anna M. McDonnell failed to satisfy her duty of due care and is therefore barred from recovery herein.

Finally, as to the last claim on the chart, the claim for $79,700, I heard Mr. Beebe and Mr. Brooks make the statement in open court this morning that that claim is based on an alleged violation of Section 6.

THE COURT: Can that be asserted against you in any fashion? It is not.

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MR. BEEBE: I am in complete agreement. I don't believe that we raise any question against him in that regard.

THE COURT: That is not asserted against you.

MR. STEIN: My reading of the complaint --

THE COURT: Mr. Beebe has just [illegible] that against you.

MR. BEEBE: It certainly was never in, and it is not intended to be in against McDonnell or its receiver.

MR. STEIN: I have nothing further then, your Honor.

THE COURT: We will stand in recess until 2:15.

(Recess to 2:15 P.M.)

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AFTERNOON SESSION

2:15 P.M.

(In open court, jury not present.)

MR. BEEBE: Your Honor, there are many ways to proceed in presenting this case. It involves various theories, at least five transactions and a number of facts on both sides of the fence. After struggling with it for some time I have elected to adopt the approach of chronology, not because it is necessarily the best but it is one way of doing it.

Before I start, however, I would like to state that in terms of a motion for a directed verdict at this point, the defendants have actively introduced exhibits and other evidence in the course of the plaintiffs' presentation of their case in chief. I submit that it is impossible at this point for the court as a matter of law to separate their evidence from the plaintiffs' evidence without coming to factual conclusions.

In the course of the robing room discussion which covered many points beyond Professor Ratner last Thursday Mr. Brooks admitted that the defendants have put in some of their case, some of their factual case, and I refer to transcript 1273. By proceeding in this manner, your Honor, the New York Stock Exchange and McDonnell & Company waived their rights to make the motion to dismiss at the end of the

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plaintiffs' case. Such a motion must be made on the facts that the plaintiff presented, without being colored or controverted by the joinder of factual issues introduced by the defendants.

THE COURT: Mr. Beebe, I don't know that you should be spending an awful lot of time on this. It seems to me the testimony here which you should be addressing yourself to is whether on this record -- I don't care whether it comes in through defendants or your evidence, but whether on this record there is a prime facie case on which the jury could find in your favor.

MR. BEEBE: I plan, your Honor, to address that point as well. What I am saying is for your Honor at this point to go along with this request, because of the factual context of the record right now, your Honor would be put in the position of having to make factual conclusions which, as you well know, of course is only for the jury.

I am saying by their choice they have put the record at the moment beyond the point where your Honor can take the case away from the jury without in some way reaching factual determinations yourself.

THE COURT: No, I don't see that at all. All I see if part of their case is coming in on some of their own witnesses, it is there. But the test for you is whether or not

on this record as a whole up to this point there is a basis for a jury to find in your favor. That is what I am waiting for you to give me.

So that aspect of that preliminary application that I should not consider this motion at this time is denied.

Go ahead.

MR. BEEBE: As far as the prime facie case which I intend to address this afternoon, I would first respectfully refer to your brief for the legal underpinnings and also refer to the very fruitful discussion in the robing room, especially starting in transcript 1275. Using those as a framework I move to the evidence in the record so far which is substantially undisputed, as, of course, it has to be because they have not put in their case.

The purpose of my effort here will be to pull the facts together and present them for their legal consequence I believe for the first time in open court in this case in one place.

Now, we first, in order to set the state for the later events at the end of 1968 and 1969, must start with the delays in receiving the audit in 1967 which is in evidence, of course, through Exhibit 68 and Exhibit 70.

In March, 1968, March 14th, the New York Stock Exchange issued a warning about disturbing minority of member

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firms whose record keeping is so poor that they needed extra time to complete their audits. That's Exhibit 78. I am not going to cite all the exhibits but I will cite some. The New York Stock Exchange at the same time also warned of possible restrictions for such delays and poor record keeping.

In addition, in a memorandum issued to all the members they warned that it is unwise to try computer conversions when record keeping is in such poor shape.

The New York Stock Exchange was setting a standard for itself, a standard which indeed it appeared to follow initially with McDonnell & Company when on March 18, 1968, they had placed McDonnell on restrictions due to the various record keeping deficiencies. That's Exhibit 79.

It sent out a detailed explanation to McDonnell of precisely what the restrictions were on page 2, 1968. It forbade the transfer of registered representatives, among other things, from other firms to McDonnell "for the foreseeable future," and corrected McDonnell specifically "not to make any further commitments of any kind which would tend to increase your business." That's Exhibit 80.

Then we come 17 days later and they lifted the restrictions. Immediately McDonnell & Company launched on its computer conversion, opened a branch office, and we have the

beginning of a departure from the strict enforcement of the exchange's own standard, and I submit the jury can find on the record to date that strange things started to happen with regard to enforcement in late April, 1968, with regard to McDonnell, not on that fact alone but if you put them together, as I plan to do this afternoon, you see a pattern and I think the jury would see a pattern.

In the summer and fall of 1968 the exchange kept a light finger on the patient's pulse. First Mr. Schuette testified the patient improved slightly, but then he deteriorated rapidly.

The exhibits in evidence and the testimony show that there were continuing and growing operations problems. There was an inability to convert the computer record keeping. The dollar amounts of the fails to receive and the fails to deliver were becoming astronomical, and there is also a serious question of when you have a fail and you don't know who the fail is from or who it is to, how do you rectify that? That's very hard. That's a little different than what Mr. Arning testified, that you can settle your accounts.

THE COURT: Let me stop you a minute, Mr. Beebe. Maybe I am doing you a disservice by sort of jogging you at a point where you are launched into a particular method of presentation. But what is it that you would have had them

do with these fails? What would you have had them do when they have a certificate and they can't find a customer and they have a customer and they can't find the stock?

MR. BEEBE: I will answer quickly, your Honor. I am in the position by Mr. Brooks' argument to take an all or nothing approach. That the plaintiffs would suddenly and precipitously pull an Ira Haupt, if you will, and close the company down.

THE COURT: I don't think he did that to you other than you may have done it in an interrogatory to them, if I am correct in that. Some interrogatory asked you that question and that's what you responded you should have done.

MR. BEEBE: The interrogatory is not here in evidence before the court now. The reason I say that is I am trying here in the court, your Honor, to prove the case of what should have been done based on the pattern of conduct which we are now proving. It is not an all or nothing situation at any given moment in time, but cumulatively it becomes very difficult, if not impossible, for the exchange to wiggle out of any action.

THE COURT: Can I, without derailing you, get you down to some time in January of 1969, let's say about the 15th, which is when McDonnell & Company first makes a written admission that their capital ratio had exceeded the stock

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exchange's limits. Now, what should have been happening there?

MR. BEEBE: May I respectfully say you are derailing me? This does goet me off the railing because the point of what should have happened there pertains to what had happened before, how much notice the exchange was on and why at that point, your Honor, they couldn't simply -- I am jumping ahead but I will do it, sir. They couldn't simply say--

THE COURT: Can you do it by flashbacks? The problem is, for example, the Dempsey-Tegler case finds that the exchange was not violating its discretionary limits in keeping the company going ten months after the capital rules violation, 325 was violated.

MR. BEEBE: Dempsey-Tegler is very much a supportive case for our position and let me explain why. The court in Dempsey-Tegler assessed a total of ten factors in concluding that the exchange should have made what it called a measured response, which is a criteria they were believed should apply here too, especially after Sloane, to the firm's problems. Among the factors noted by the court in Dempsey-Tegler were, one, the imposition of restrictions on Dempsey-Tegler's business in response to its initial record keeping violations.

Two, the sanctioning of Dempsey-Tegler management, sanctions and subsequent installation, installation by the exchange of new leadership in that company.

Three, the disclosed, and I wish I were writing on a blackboard and I would underline the word disclosed, solicitation of new capital by the subordinated lenders. When they went, in Dempsey-Tegler, your Honor, to mise new capital they told the new capital lenders about the condition. They disclosed and set certain -- and this is in quotes, "Under certain conditions that were carefully and clearly communicated to the two proposed subordinated lenders, Hughes v. Dempsey-Tegler at 94, 545."

There was a conscious decision not to suspend Dempsey-Tegler but to try and solve its problems by the infusion of new capital and the imposition of restrictions and sanctions, but it was a disclosed decision and the exchange's own doubts about the firm's recovery were fully disclosed to the subordinated lenders. A complete listing of that, all the factors, appears in the Dempsey-Tegler case at 94, 545 to 546.

THE COURT: Why don't I let you go back on the track you wanted to follow because your contention is that in and around February 1st of 1969 that the exchange was on notice that this firm was going to go bust. That's about what

it amounts to.

MR. BEEBE: My next step is in the flashback--

THE COURT: And therefore unreasonable by letting anybody put any money into it.

MR. BEEBE: I can quickly cover up to there.

THE COURT: I don't want to derail you.

MR. BEEBE: I wouldn't mind in normal circumstance jumping around but this has so many darn facts and circumstanc that I would certain appreciate doing it this way.

Arbitrage, which is the next thing, in August, 1968, the exchange makes its first interpretation of Rule 325 as it applies to these clients. The examiners said, and this is the people down at the lower levels who are gathering the facts and putting them in order, they say arbitrage is not good capital. I think Mr. Greaves so testified. McDonnell begs, please give us a "less favorable interpretation because that can materially affect our functions as a rights specialist." That's Exhibit 71 or possibly 72.

McDonnell admits that the arbitrage position they want is "not in accordance with Rule 325." That's a quote from Exhibit 71. But then they have a telephone conversation there and they are quite upset when they are told by the examiner, doing what he should have been doing, that the SEC would have to be informed.

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The exchange then gets to the higher levels and the higher levels say, McDonnell, you want this interpretation, we will give it to you. You get the arbitrage interpretation you want. You are not going to be in capital violation. The first crisis has passed.

THE COURT: Is it claimed they shouldn't have done that?

MR. BEEBE: My question is, as we move along, why is there a consistent pattern? I can't take one piece of the puzzle out at a time. I say why is there a consistent pattern of favorable -- every time, favorable interpretations to the exchange, refusal to enforce the rules by the exchange? Remember that pesty question I kept asking the people from the exchange, with all this information what did you do to act? If you didn't, why didn't you? There was no one who gave me an answer until we came to the very last day.

THE COURT: Mr. Brooks, take your arbitrage-- Mr. Beebe, excuse me. Have we any proof here that the ruling on the arbitrage allowance was outside of the bounds of discretion?

MR. BEEBE: We have proof of a pattern, your Honor, that when the exchange examiners, lower people, say we do it this way, this isn't something that is isolated and comes up for the first time at the higher levels. The lower people

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say you don't do it that way, you don't give them credit for the arbitrage. Then they are told by McDonnell that if we don't get it this way, we are going to be in violation. Then someone upstairs says, that in that case we will give you the special interpretation. No public announcement, no MF bulletin, no going down to the SEC. Why not? I refer to Exhibit 86.

THE COURT: Does the record show that McDonnell people said if they don't get the arbitrage --

MR. BEEBE: Yes, sir.

THE COURT: -- ruling they will be in violation?

MR. BEEBE: "Materiall affect our functions as a rights specialist." We have to go to the SEC for a special ruling. I think that's Exhibit 72. The McDonnell people are told and the McDonnell people themselves say with the arbitrage interpretation being given to them by the exchange people, unless it is reversed by the higher-ups, the interpretation we want is "Not in accordance with Rule 325." That's Exhibit 71.

THE COURT: They are not put in violation.

MR. BEEBE: Unless they get what they want.

THE COURT: My question was whether there is any proof that if they didn't get that ruling they would be in violation of the 2,000 per cent. I gather there is no

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proof of that.

MR. BEEBE: I would just say I believe there is, sir, because the exhibit says that with the ruling you have given us, that is the exchange examiners have given us, we are "not in accordance with Rule 325."

THE COURT: That's not what I heard before.

MR. BEEBE: I didn't state it right that time. They are saying we want an interpretation. We know that the interpretation we want is not in accordance with Rule 325. Then they are told since that is what you want you have to go to the SEC. Then they say -- they don't say but then they go upstairs and upstairs gives them what they want.

I have to admit, sir, as of this point in August, '68, I still haven't established enough of a pattern to convince myself, so I don't know how I can convince you or the jury. But it goes on, it goes on.

We get to October 24, 1968, and in connection with the arbitrage interpretation and exchange examiner notes in a handwritten note for the first time that what McDonnell really needed was not interpretations, they needed more capital. That's Exhibit 60.

Mr. Schuette, Mr. Schuette struck me on the stand, and I'm sure the court and jury, as a conscientious exchange

examiner. He compiled a handwritten summary of McDonnell's "progress and lack of progress from early 1968 to October 28, the first." This was forwarded to the head of the department Exhibit 35A. Mr. Schuette was constantly recommending the imposition of further restrictions but his pleas fell on deaf ears.

Mr. Schuette on November 4th met with Mr. Bishop and two other examiners to discuss McDonnell's problems but they deferred action. Exhibit 36.

By then, by then being November 7, 1968, McDonnell-

THE COURT: Up to that point we have problems but no violations; right?

MR. BEEBE: I can't tell you whether violations. Nobody dug deep enough to put them on the record.

THE COURT: On this record we have no violations known to the stock exchange.

MR. BEEBE: Well, if you hadn't had a good interpretation in the arbitrage you would have had a violation.

THE COURT: That's your conjecture. The record doesn't support that.

MR. BEEBE: I would have to agree with you, sir. I would have to go on and say I think what the record also supports is there should have been much more digging done and much more restrictions imposed to get things back in shape.

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When we talk about violations, remember now there are bookkeeping violations which is Rule 440. There are 325 violations which have to do with capital. Rule 440 violations are what led to the imposition of restrictions primarily in April of 1968, on the very day that I am just talking about, November 7th. We have a typed, hand typed note that says to Mr. Schutte, "McDonnell & Company has lost seven or eight vice presidents; its operations man, Sean McDonnell, has died. McKay is in poor health. Their operations and control is therefore said to be declining rapidly." I apologize for the grammar. That's how it appeared in the exhibit, which is Exhibit 35A. That was signed by Mr. Bishop.

"Declining rapidly." Then he asks for a comparison between the April period and the present period. It may be a good time to reimpose restrictions. Anyone, certainly the jury, can find at that point it was past the time to reimpose restrictions.

I can see arguments coming in from the other side that the report was never made, how can the jury conclude that? But something certainly should have been done the beginning of November, 1968. Despite those early warnings and the obvious deterioration of the firm's condition, in an admitted document from their own side, the jury could conclude from the evidence that the exchange too, no positive

action and there is no good explanation for why they didn't.

THE COURT: Mr. Beebe, absent a violation can it possibly be an abuse of discretion for the exchange not to do something?

MR. BEEBE: I have alluded to, I believe, Alice in Wonderland in the opening statement and the reason I did that is if you purposely ignore a fact and you just say that fact doesn't exist, then by some means of logic, and I would say it is Alice in Wonderland logic, you never have to treat the fact. You can ignore its existence forever. If you don't deem it a violation, somehow it never becomes a violation.

THE COURT: You have a situation where the firm is sending in twice a month their 325 statement; is that right?

MR. BEEBE: Right.

THE COURT: And it reads right. Lybrand has made their surprise audit and its results are awaited. Don't you think that if the exchange had gone in and said that you do this, that and the other and McDonnell could have proved they lost a half million dollars in sales, that they would have had a legitimate gripe?

MR. BEEBE: I have two answers to that. Point number 1, there is something you can do that's short of shutting a firm down. On a 325 violation, if it continues for more than a few hours, Mr. Arning had never heard of it for more than

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a week, surely then you can take an extreme step like that. There is something short of that that can happen. You can tell a company, just as they did, stop expanding, slow down your operations.

THE COURT: But they are not in violation of any rule.

MR. BEEBE: I think there was clear proof that they were in violation of the rule requiring adequate record keeping. They hadn't been able to report their box count which Mr. Arning testified is good practice to do more than once a year.

The reason this occurred was their record keeping was, as I believe he also testified to the effect, and I forget the exact word, but disastrous.

My second point in answer to your question is Exhibit 83, the charge memo. The charge memo is an admission by the stock exchange that -- and it states --

THE COURT: What is the date?

MR. BEEBE: 1970. It looks back at the whole series of events and says, starting in October, 1967, just where I started this afternoon, it disclosed "substantial and unidentified fails, unidentified transfers, unlocated security differences and error counts."

THE COURT: A lot of people have it. They were taken off restriction. And on this record there is certainly

no violation known to the exchange until mid-January, '69.

MR. BEEBE: I guess what I am saying is that the jury could well find that the situation by the end of 1968 was substantially worse than it had been earlier. If the earlier standard was applied consistently at the end of '68 they would have been put on restrictions again, at least. They were in violation.

THE COURT: It doesn't seem to me that's the testimony. It seems to me the jury has got to find not that they shouldn't have been put on restrictions, but that the failure to put them on restrictions was a violation of the stock exchange's discretion.

MR. BEEBE: I think that what the jury can find is that it has to have some standard to measure what the exchange should do and it has two inherent, in the confines of this case, standards to use. What it did before and what it did afterwards. Both of these, as I continue the recitation this afternoon, relate and focus in on January as a measure of what should have happened before or at January.

I think this charge memo, sir, is extremely important because it sets forth by themselves what the exchange thought were the violations. It is called just that, violations. And the violations are in the exhibits

attached, which unfortunately are not indexed, and they relate to this entire period.

Now, November 7th Schuette is asked for a report. He never renders the report, comparing the two. The last thin we have in the documents, in the exhibits is that the operatio and control is therefore said to be declining rapidly.

Why didn't the exchange act? Maybe it is, as you ask, your Honor, that the exchange had a perfectly good reason. It looked at the situation and made a good faith judgment, it made a measured response on the Dempsey-Tegler test and the measured response somehow led to the conclusion they shouldn't act. All I know are the facts that we have in front of me. But on the facts as they now stand, and we are talking here about a question of a motion to throw the whole case out, the facts as they now stand do not come anywhere near that conclusion. They support the contrary. There is no decent explanation for what happened. There is an indecent explanation; that is, they suspend the rules in connection with McDonnell.

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THE COURT: What is the abuse of discretion as far as November 7th?

MR. BEEBE: I will ask you to wait until I have presented the whole thing.

THE COURT: All right.

MR. BEEBE: We know about the chronology in the substitution of the Series B bonds for the Series E bonds by a series of internal memos. The evidence in the record shows that the approval of two trustees was required. That only one trustee signed the approval, that there was not even the formality of putting on a second trustee's signature This is Exhibit 19C. And even that one trustee should be disqualified due to a blatant conflict of interest in his position at that point as the head of this company. He should not have signed it as a trustee. It is undisputed that the exchange obtained and checked trustee instruments. There was more on that this morning when Mr. Brooks was trying to argue that the Manufacturers Hanover Bank and the exchange correctly discharged their duties by referring to a trust agreement in this case. I wish they had done that here, as they well should have.

THE COURT: The testimony, as I remember it, the only time the exchange would go into a trust instrument would be to see if a particular action was authorized. I

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think the testimony was to the contrary on saying whether a trustee appeared to have signed pursuant to an authorized fact.

MR. BEEBE: I remember that testimony. I am not saying they did it. I am saying they should have done it. I think you are right in your recollection.

THE COURT: They checked on the procedural aspects.

MR. BEEBE: I remember they would check on the initial transaction, and then if there was a subsequent roll over transaction they would not check again. I think there are two things that are different in the situation. One is the exchange did check and should have checked in situations where it had so much involvement in the particular transaction, and in this case, this is not a transfer done at some registrar agent's office. This is a matter of a funding of one of the members of the exchange, a funding which they files on and which they certainly had a duty to look into on behalf of the investors.

THE COURT: If they had called Murray McDonnell up he would say, "Sure it is authorized." Would the exchange then say, "Well, I don't trust you. I am going to talk to James"?

MR. BEEBE: In the Manufacturers Hanover case they looked at the trust instrument.

THE COURT: The underlying transaction they questioned there. They did not check on the procedural transaction.

MR. BEEBE: This is the authorization I am talking about. This is exactly what they should check on, because they had the records in their own file.

THE COURT: That is an impossible burden.

MR. BEEBE: There are not that many such instruments. And that raises an interesting point. There are a number of arguments along those lines, that someone else did or didn't do something right. Well, let us assume for the moment that the exchange says they rely on Lybrand to do it right, and just assume for the moment that Lybrand does it completely wrong. Now my question is, it would certainly be a wonderful world for the New York Stock Exchange and others to make that kind of a delegation of duty if they could simply say, "Well, Lybrand did it wrong, therefore, we no longer have primary responsibility. Go sue Lybrand. Certainly, if Lybrand did it wrong and the New York Stock Exchange was relying on Lybrand to do it right, that is between Lybrand and the New York Stock Exchange.

THE COURT: These are McDonnell auditors; these are not stock exchange auditors.

MR. BEEBE: They were relying on Lybrand.

THE COURT: These are independent auditors of McDonnell.

MR. BEEBE: If the independent auditors did something wrong?

THE COURT: You would have the reliance go all the way down the line? Where would you stop?

MR. BEEBE: I would say that the procedure has a lot of attractiveness to it, just like you have lawyers, you hire a lawyer and hopefully he will provide you with a good will. But if he does not, or not a good contract, it is the person who is entering into the contract who has the primary responsibility. Taking the contract example, can he turn to his lawyer and say, "Why did you leave out that clause?" The buck stops with the New York Stock Exchange. I am not saying the procedure is wrong to turn to Lybrand, but where the responsibility continues is with the New York Stock Exchange, and it can turn to the outside auditors and say "Settle up with us." For all I know, they have cross agreements with these people. They could have brought them in as defendants if they had an active tort feasor role. But as far as primary responsibility is concerned, there is no way to my mind for them to get out of their primary responsibility by turning and pointing the finger to someone else.

I can now skip over my next paragraph, because that is just what I had here.

Now, as to the American Stock Exchange, we all think along the same lines, and this really goes to the point. That is an interesting point, but they just have it wrong. They continue to have primary responsibility. And the American Stock Exchange, despite its attempts to maintain a low profile here, was equally negligent. It received notice of the purported substitution in Exhibit 19F and on this record it ultimately and utterly failed to check on the underlying authority or lack of authority, and it remains primarily responsible. It also attempted to delegate its responsibility, and now I will shift to Section 6 for a minute, because it is a convenient point to talk about it.

It says under Section 6 that despite the fact that the American Stock Exchange signs an agreement with the SEC, despite the fact that the American Stock Exchange is a national securities exchange, registered and so on, it can delegate responsibility to the New York Stock Exchange, but, again, I think there is a lot to be said for having only one group of auditors come running in and doing the checkup in a normal company that does not have any problems. But they don't delegate and they can't

delegate as long as Section 6 is in existence the responsibility for enforcement. It is a principal agent. I am not saying that there is anything criminal about it on its face, but if you have an agent and you rely on him and he, in turn, fails to act properly, and here I am hypothetically saying the New York Stock Exchange completely failed in its Section 6 responsibility as delegated by the American Stock Exchange, can the American Stock Exchange come in and say, "They failed; we did not fail; therefore, they are responsible"? That is not how Section 6 is written.

THE COURT: If you go on that theory, you have eight exchanges, an exchange in Honolulu, and the exchange in Honolulu receives the notice that McDonnell is in violation, then that exchange in order to protect itself would have to come in and say, "Well, what is going on?" And you would have eight magpis sitting around with eight different ideas of what should be done. And by the time you got through, if they didn't agree, the place would be torn to pieces, each one acting according to his own discretion. If you take it that far, that obviously would be absurd. If you had eight Mr. Bishops and each one had a different idea, one saying, "Leave it open," the other saying, "Let's close it," that would be just silly. If you rely on your statutory scheme, it would seem to me

that scheme would provide that one of them will do the action.

MR. BEEBE: I have an answer for that, first, that that is clearly a sensible approach. You can't have a group of Mr. Arnie's or Mr. Bishop's or what have you each taking inconsistent positions. But let me give you an example of multiple defendants in a case where they all have some similarity of interest. It may be to their benefit to hire one counsel, who despite the inconsistent interests, will, at least, present a united front. Now, let's say that that one counsel is primarily the counsel for the New York Stock Exchange in this example. It has absolutely nothing to do with the present situation. But let us say the New York Stock Exchange had completely failed in its regulatory duty delegated by Honolulu, completely failed. Now, can Honolulu say in turn to the person who relied on the Honolulu exchange, who lives in Honolulu, the person who is a resident out there and trades on that exchange and has nothing to do with the New York Stock Exchange, can the Honolulu exchange say, "Don't look at us any more; look at the New York Stock Exchange?" That is not the way it works at all. The man who has a valued claim looks to the Honolulu exchange. Those are the people he dealt with. They, in turn, can go over to the

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New York Stock Exchange and put the matter ultimately where it belongs.

THE COURT: Wouldn't Honolulu have to impose its own regulatory scheme first?

MR. BEEBE: Maybe the Honolulu or the American Stock Exchange if they had done a little more about taking on their own responsibilities and looking over Mr. Bishop's shoulder and Mr. Arnie's shoulder, if it had played a more active role and not delegated its responsibility to somebody else, would have acted in its own interest. I think there is that delegation for which they are responsible.

THE COURT: Can't Congress say to the SEC to set up these exchanges in a particular way and the rules shall be agreeable, and if a rule is agreeable to the SEC, which is, that if a firm is registered in more than one exchange, only one shall do it and that is the end of it?

MR. BEEBE: I think Congress could have done that. What Congress really said is that you can adopt rules and the rules can say that the member exchange's functions can all be performed by one exchange.

THE COURT: The mandatory functions.

MR. BEEBE: They didn't say that, or Mr. Lufkin didn't say that. He didn't refer to the regulatory functions

being delegated. He referred to basic financial oversight.

THE COURT: Can't you put in the other?

MR. BEEBE: You can't get rid of your enforcement responsibility without violating Section 6 altogether.

THE COURT: The practical matter is where they got the financial information they just didn't do the regulating?

MR. BEEBE: That is right. I think that sums it up very well.

Now, the other point I have on that, which is quite important, is that we have in evidence, sir, a document that shows that the American Stock Exchange actually did perform some regulatory duties in this case. There was an investigation of McDonnell's Washington office, Exhibit 42. This was in April or so of 1969. McDonnell's Washington office was investigated. It had something to do with margin accounts. It was not the SEC. It was the New York Stock Exchange, it was the American Stock Exchange. They knew what they had to do. They had regulatory duties.

THE COURT: Yes, but you don't attribute any results in this case to anything they, in fact, did?

MR. BEEBE: No.

THE COURT: You are using that for what purpose?

MR. BEEBE: For the purpose of showing they did

have a regulatory function, and just to depart and leave the American Stock Exchange out, I think it would be very ironic if at the end of this case the jury is given these questions to find and finds that the New York Stock Exchange was completely responsible for failure to regulate and the American Stock Exchange had somehow gotten off the hook and never even got that far in the case, because both are equally responsible. What I am saying is that if the New York Stock Exchange is completely absolved of all responsibility of the controlling person or 10(b)(5), or Section 6, or all these other theories we have here, the aiding and abetting, then I might be very hard pressed to say the American Stock Exchange is responsible. But the converse is also true, the converse being that if the New York Stock Exchange is responsible as the agent, if you will, for the American Stock Exchange, then, surely, the principal is responsible too. Mr. Loflin's client admittedly gave everything over to the New York Stock Exchange and said, "You do it." I think I have exhausted that point for the moment. I think we then go back to the lack of action, as I call it here, the events of January taking place and precisely what was done in January.

Some time before January 9, 1969, Mr. Schuette learned from his examiner, Mr. Schuette being a coordinator,

that the audit would show a net capital violation. Mr. Schuette could not pinpoint as to how far back before January that occurred. So we can't argue a specific time. I think the jury could fairly infer that it was when the audit was in progress some time after October 31, 1968, and perhaps in November or December. But, in any case, here we have January 9th, and that is not when Mr. Schuette first testified he learned of it.

He testified that on January 13th he wrote a memo about a phone call from Mr. McKay, and Mr. McKay said he would raise 1.2 million dollars, and he said the firm was looking for other funds. This was not a matter of switching around the bookkeeping to make the shorts and longs trade off against each other. They were going out to get that money. In January, 1969, early in January, 1969, they were going out and beat the bushes and raise some money. The first thing they talked about was that the firm, according to McKay, had been in violation and was negotiating with an institution for more subordinate funds. This is not some family that they were going to get this money from. I will come back to the family situation later. But this was someone else, some other group, an institution, that they were going to raise funds from . Now, as Arnie testified, when this kind of information came in, it went

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to the top boys in the command. We submit that the jury could find on the evidence to date that the exchange knew or had strong reasons to suspect at least by the beginning of the year that McDonnell & Company was in violation of its basic capital requirements. And here are some of the material adverse facts which we have gone over this morning already, that the exchange knew at that time. Now, I am talking about an affirmative knowledge. They knew that there was a violation of the rules. There was a memo, and the charging memo is very interesting, and it speaks of loss of key personnel, the withdrawal of two partners taking some $400,000 with them. That is Exhibit 37. There was inability to complete the computer conversion, and that was first promised for July 4th, and there were capital problems that amounted to violations, and these things were thoroughly known to the exchange, and, of course, to McDonnell & Company.

Now, the Lybrand audit arrives. Is shows a net capital violation. The jury could find from the evidence that the public summary of Lybrand's audit, that little Exhibit J that was issued to all the shareholders, failed to reveal the existence of the net capital violation only three weeks earlier or accurately portray the condition of the company, failed to reveal that there had been an unclean letter issue, which is a very material fact when an auditor comes in and says I can't give you a clean letter.

The jury could find this, and I'll come back to how that applies to each of the plaintiffs the next page.

THE COURT: Keep in mind you are talking now about whether anything the stock exchange did or shouldn't have done was a violation of discretion rather than whether something is a possible material misrepresentation, because you sound like you are arguing a 10(b)(5) case this minute and we are talking about whether the exchange got off the reservation.

MR. BEEBE: I'm presenting a chronology.

THE COURT: I agree with you, we can find that one could conclude this, that and the other. But the question is whether the response was in the

discretion or without the discretion.

MR. BEEBE: I rely very heavily on the 19(b)(5), and I will show that in a second -- a minute.

The examiners' analysis when reviewed at the coordinator's level showed that this was no 2001 violation. By January 28, 1969, Mr. Schuette wrote a memo showing a ratio of 3992 per cent, charging the short record differences. Mr. Brooks mentioned this morning 2717 per cent, I believe. That was without charging the shorts. In that very memo Mr. Schuette wrote in his own handwriting against the short record difference question: "charged."

Now, why did he do that? Despite a lot of talk about preliminary analysis, and this has been mostly in the objections and cross-examination, and "apparent violations" -- I should also say the witnesses volunteered those words quite often, especially the lower level ones, "The exchange's own final findings could not white wash away the fact that the ratio as of October 31, 1968," from the best possible way of looking at it, "was 2512 per cent." That's in the final charging memo.

The examiners' January 28th memo noted that the short differences were charged, according to the handwritten note, but then someone upstairs started

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changing things around.

On January 29th the exchange met with the McDonnell officials and Mr. Bishop came into the room. According to the only evidence before the jury Mr. Bishop walked in, stood behind the chair, announced to the assembled group that McDonnell & Company had to raise a specific amount of capital by such and such a date, and walked out.

Nothing about how to do it, who, what they would know or wouldn't know, what they would be told or wouldn't be told. We will come back to the significance of this in terms of both 10(b)(5) and section 6 under the Dempsey Tegeler facts and law.

The subordinators, next heading, Mrs. Anna McDonnell --

THE COURT: Let me stop you a minute there. What would you have them do at that point?

MR. BEEBE: For one thing, I wouldn't have them go out and raise money without telling people what the problems were. In Dempsey Tegeler they did tell the people.

THE COURT: Let's stick with McDonnell. What would you have Mr. Bishop -- what is he going to direct Mr. McDonnell to tell people? Items 1, 2, 3

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and 6 or 1, 2, 3, 4, 5, 6 or 1 and 2? Suppose he misses one? Does that give you a lawsuit later because he missed one?

MR. BEEBE: There is something called a knowledgeability letter, your Honor.

THE COURT: Let's get there later. I have some questions under that. Because a knowledgeability letter doesn't tell anybody anything. All it says is that we want to be sure that you know what you are doing. It doesn't say the company is in violation of the rule. It doesn't say we lost seven executives. It doesn't say anything. It says you are telling us that you have satisfied yourself. You are not going to sue us. That's really all it says. So it doesn't give anybody any knowledge. It just says you will give us a representation that you know as much as you want to know.

MR. BEEBE: That's how Mr. Brooks would characterize it.

THE COURT: On its face that's what it says.

MR. BEEBE: As I stressed, your Honor, the real function of the knowledgeability letter as far as our clients were concerned is that it would put them on notice they had better look into this. It's like you have on top of a contract form, the way it's done nowadays

when a little fairness is required in dealing with people who may not know as much as somebody else, consult a lawyer, this is a legal instrument. It says look into the company, there may be some problems. They imposed knowledgeability letters on everyone later on.

THE COURT: I mean this letter has to be very carefully written in order to avoid libeling somebody in the solicitation of funds.

MR. BEEBE: Let's say you have a company president who knows --

THE COURT: Mr. Beebe, you slipped away from what I originally asked, which is what would you have Mr. Bishop require Mr. McDonnell to tell people the end of January in getting money?

MR. BEEBE: I was going to answer that as I started to do. Suppose you have a president of a company. I'm not sure if all the connections are going to work in this example, but he learns a material adverse fact about a company and he learns that the vice president of the company is selling his stock and, say, the buyer is someone who has a legal connection with the president --

THE COURT: Please, not hypotheticals but stay with this case. Mr. Bishop tells Murray McDonnell

you get up $500,000 by Friday, period. What else should he have said?

MR. BEEBE: What he should have done, if he were going to deal fairly, I believe the jury can find what he should have done was establish a procedure to assure that when -- we are assuming that the stock exchange has an interest in this, which I think is evident but we will also prove that -- establish a procedure so that the people who are going to be receiving this solicitation find out the material adverse facts that aer known to McDonnell and the stock exchange, and also he should not have, although he acted very late in the day, he should not have permitted this kind of solicitation to take place on virtually 24 hours notice because it's almost a prima facie fraud.

There is no way that a person in Mrs. Murphy's position or the other position could find out, absent some sort of detailed disclosure to them, all of these facts on 24 hours notice.

THE COURT: Then she doesn't give her money.

MR. BEEBE: That's exactly right. The exchange so desperately needed thatmoney that they were willing to blink at the requirements.

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THE COURT: You are saying the exchange abused its discretion in saying I want $500,000 by Friday, period.

MR. BEEBE: In the method of solicitation without the safeguards. That's right, sir.

THE COURT: I'm trying to be really very concrete and I am trying to see what you say should have been done.

Was this done on the telephone?

MR. BEEBE: Yes.

THE COURT: Which makes it much more difficult because you end up being misquoted. Let's assume you don't have that problem. Should Mr. Bishop have said, now, Murray, I want you to tell them this, this, this and this?

MR. BEEBE: Murray and Bishop met in person.

THE COURT: I am trying to receive from you what it is you contend exactly what he should have said to the person he was talking to?

MR. BEEBE: I will answer it as precisely as I can, your Honor. Since we are faced with a body of law regarding material adverse information, Texas Gulf Sulphur and a great many other cases which I know you are aware of and I have dealt in a gooddeal, when you

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have a material adverse fact you have to take steps to make sure it gets in the hands of the guy who is going to buy.

Now the material adverse facts are, and we have gone through them, a violation of the capital rules, a violation inthe operations, all the other violations recited in the charging memo, the fact that, at least the jury could find, the two partners had just withdrawn $400,000 and the other violations we talked about and the other material adverse facts. Then there may be more of them coming in.

THE COURT: Mr. Bishop has to see to it that that's what McDonnell says to them when they give their money?

MR. BEEBE: When you have adverse facts you have to take some steps, if you are going to conduct yourself properly, to make sure that the people who are going to be solicited learn about them. That's how I understand how the rule works.

The reason I put that under both 10(b)(5) and section 6 is that's what Dempsey Tegeler says. When you have an attempt to raise funds under section 6 and your measured response is the criterion, whether your measured response is good or bad, one test they applied

there, and they applied it against the plaintiffs in that case, was you have to take a measured response to make sure you are dealing fairly with the -- I'm sorry to use the word pigeons, but you are dealing with the people who are coming in fairly.

THE COURT: The problem I see is that since the exchange is not the borrower, how are they going or how can you ask them to be in the supervisory position of seeing to it that every material fact is laid out?

MR. BEEBE: There are three answers to that, sir. One of them is that, as you know, the controlling person doctrine is very applicable here. I think the jury could find that the exchange was in a controlling person position as to McDonnell.

THE COURT: I disagree with the Hughes case, but that's another matter.

MR. BEEBE: Let me pass that, but I will come back to it later. Also here you have one party soliciting the funds and another party is the guy ordering it, it's again agency and principle. You are saying to him go out and raise the funds. He goes out and raises the funds. One practical solution you could have is to have the people write a letter, and you don't have to call it knowledgeability letter. I only work on that

because that's the one they used here. You call it a letter giving them notice, saying please give notice to anyone you solicit funds exactly what we went through.

They didn't do that, nor did they take steps to try to do it. In fact, it was just the contrary. They didn't want to do it because the funds wouldn't have come in. That's the rest of my story.

The rest of my story does not say after Jim comes in, if I can skip ahead a little, after Jim comes in my story is not primarily a section 6 story. I am not saying late in the year that they should have done this or that move differently or treated the alternatives in one way or another. I will get to that because it's very important to what is happening later on in relation to what happened in January.

THE COURT: Would you want to take a break or go a little longer?

MR. BEEBE: I wouldn't mind a break. I will take any offer that is reasonable.

THE COURT: All right.

(Recess)

(In open court)

MR. BEEBE: May I proceed?

THE COURT: Please.

MR. BEEBE: Sir, just to round out what should have been done in January 1969 under a pure section 6 obligation, just limiting it to that narrow area, consider what they were faced with. Consider that they were faced with a year's history of serious operating and record keeping problems, not de minimis, not something that you could easily pass over. Something so serious they had to impose restrictions on before and I submit they should have done so again. Record keeping proglems which led to the capital problems I think a jury could farily conclude.

Here they are in January with all these problems. It was, if you will, analogous to a big hole, a big hole that one could fall into. It's a dangerous hole. The way to fix that hole is to fill it, to fill it by curing the operation problems, record keeping problems. To take strong measures, to take vigorous steps to impose firm restrictions, sanctions, fines, censures, something to make them move, to make them stop this attempt to convert to the computer which they didn't stop until the next summer. Make them clamp down on the record keeping problems. To make them stop eating into their capital because Mr. Brooks said they were a profitable company and as the record will show

they became an unprofitable corporation at the end of 1968 and were losing $700,000 or more as the year progressed.

They didn't fill the hole in, they didn't. They didn't take steps to do that. What they did is put a big piece of plywood over the hole and that was more capital. That's what they reached out for alone. A measured response would have done both. A thin piece of plywood made up in large part of our client's capital.

As Mr. Brooks said I believe in his argument earlier, there was a lot of money. Well, perhaps there was some money that Mrs. Murphy had in an account, Anna McDonnell, Mrs. Anna McDonnell had in stocks in a safe deposit box and it was reached out for and used to paper over this problem and nothing was done underneath.

THE COURT: Weren't they being told all along that they were working on this and working on this and working on this and we need a little more time, need a little more time?

MR. BEEBE: I think the jury could find, sir, that this was so much talk. They weren't working on it. They didn't need more time.

THE COURT: On what basis could the jury

find it was talk?

MR. BEEBE: I believe from two things: One, lack of positive firm steps taken earlier. Three things. Two, the steps they did take later. Three, and perhaps most important, Exhibit 86, Mr. Haack's special membership bulletin, because that's the confession.

THE COURT: Read to me the place you say that makes their continuing statements about record keeping correction false.

MR. BEEBE: It makes everything else understandable. This is the cap stone.

THE COURT: False.

MR. BEEBE: "In the case of three major member organizations the exchange found itself facing situations where normal application of the rules could have meant possible loss for many thousands of customers and potential chaos in the industry. One of the three firms is McDonnell."

Sir, that translates very readily because people don't talk when they write memos like this in direct language. They talk in euphemisms. It's pretty clear that it translates into non-normal application of the rules which was done in the case of McDonnell.

Was there a unicorn?

THE COURT: I agree with you. But to them the question is whether non-normal application was an abuse of discretion. The starting point we had was whether the exchange wasn't entitled to go along with McDonnell when they said we are getting this record keeping in hand, we are working on it, we are getting the IBM's in and we are getting rid of the NCR. You say they shouldn't have trusted that.

I am saying what evidence is there in this record that should have put them on notice they shouldn't have trusted them?

MR. BEEBE: The main thing is, sir, that the Securities Exchange Act does not permit the exchange to make the judgment that it will suspend normal application of the rules. Mr. Brooks made a very important concession I find this morning. He said there was a procedure for an exception to rule 325 but we are not contending that that procedure was followed here.

They didn't make a public exception to 325.

THE COURT: We are not talking about 325. We are talking aboutrecord keeping.

MR. BEEBE: This talks about both. In terms of record keeping, sir, if they had a non-normal

application of the rules, that's a major departure from what Congress mandated. Congress said thou shalt have these rules. It didnt say that you could suspend enforcement of the rules; that you could have "non-normal application," which is just a fancy way of saying they didn't enforce the rules.

Yes, sir, that is exactly what it means.

THE COURT: I'm not sure I read that quite the same way.

MR. BEEBE: I believe I can be convincing on thatpoint because it's the only explanation for what happened that makes good sense in the context of the whole thing.

THE COURT: Mr. Beebe, let's assume there is just a modest record keeping problem, just modest. There is a problem. It doesn't cause any concern to anybody. I would think the exchange might let that go on for years; all right?

MR. BEEBE: It's possible.

THE COURT: We have here an immodest situation. We have 50,000 customers. We have the company saying that we are going to cure this. We are working like hell on it. We are getting in ndw stuff, hired extra people. We have hired three people for the

cage. Don't you think that the alternative is to keep them going and let them try to solve what they say they are solving rather than doing, I don't know what else, you tell me what else; shut them up?

MR. BEEBE: The main problem I have -- that's certainly what someone would hope would happen. Surely --

THE COURT: I keep coming back to what troubles me here, and that is, and I am sure you sensed it, that is that Congress in passing this bill gave the exchanges under SEC supervision enormous discretion to deal with non-normal situations, if I may call it that, because the exchange was recognized to be an unpredictable animal. As I seem to read some of the legislative history, they didn't want ot be too concrete in the rules because they never were sure of what might pop up next.

MR. BEEBE: I think as far as the non-financial rules that's exactly right.

THE COURT: So we then have a situation where you had an enormous company that's been profitable, you have an unexpected paper situation, you have a record keeping problem. How do you deal with it? The stock exchange dealt with it one way. It seems to me that for you to prevail you have got to do more than say

they did the wrong thing. You have to say it was an abuse of discretion for them to do what they did.

MR. BEEBE: I intend to prove precisely that. I think that we have proved so far --

THE COURT: It isn't a question of that you intend to prove it, I need from you a recital of the facts in this record thatwould permit the jury to find that they did. That's what I really need.

MR. BEEBE: That's why I keep coming back to my progressive recitation of the facts as they emerged here. I am approximately halfway done.

Let me not defer answreing that question. Let me give you what my view is. I am not going to substitute myself inthe place of somebody acting in good faith who is an expert in doing things the way they should be done if they will do the things the way they should have done, the way they have been done in the past, the way Congress mandated them.

One question in my mind, and I kept asking witnesses this, why didn't they act faster? It's one thing to say there is route A, B or C thatyou can take or McDonnell saying give us a little time, we aregoing to convert to computers, just give us a little time. That's why I go back to 1967 because the time was running a long,

hard way. The only way they got the time, the only way they bought the time was with our client's money. They couldn't have survived except that they used our client's money to gamble with the time.

So our clients were entitled to something in exchange for their money. What they were entitled to was enforcement of the rules the way they were to be enforced.

Maybe, sir, I would have to go along and say give the guy a little leeway and it's only 2000 per cent. Give the guy a little time. I asked Mr. Arning "How much is a little time?"

THE COURT: Arning said his predecessor would give them 20 minutes or an hour or two hours or something like that.

MR. BEEBE: He never heard of one that was more than a week and he said McDonnell was no exception. But it was an exception because Mr. Arning wasn't telling us exactly what we know.

THE COURT: Mr. Bishop said that you have until the end of the week for a half million dollars. Now, it seems to me that that's giving them some time. Apparently for that violation of the rule he could have chopped them off at that point.

MR. BEEBE: If you are under the impression from some brief that has been submitted that I am saying that a week to raise $2 million was --

THE COURT: Half million.

MR. BEEBE: Or any amount of money is unreasonable, no, no. I am not saying that. We were talking about record keeping.

THE COURT: Then you get down to the problem which you raised earlier of, is he going to be responsible for seeing that it's raised without fraud?

MR. BEEBE: That's certainly true.

THE COURT: That's the next question. It seems to me that if he has the power to say that we are going to cut you off this minute and in his discretion he says, no, we aregoing to give you a number of days, he is certainly entitled to assume that Murray McDonnell is going to obtain it legally. He is not going to assume that Murray McDonnell is going to go out and rob a bank.

MR. BEEBE: I would have to differ with that 100 per cent. If he is going to say just because Murray is going to do it, I know it will be legal. I am sure I can convince the jury to the contrary.

The man can't take half a loaf. He can't

go out and say I am going to raise the funds, even if it takes a week, and not do the other half. That's why I thought I was responding to your question when you said how much time can a guy have to do record keeping repairs, if you will, to fill in the hole. How long can he have? I don't know. But I think the jury could find from the evidence to date that they took too darn long.

The reason they took too darn long is they were making an exception for McDonnell. They reason they were making an exception for McDonnell has nothing to do with regulatory function, which is what I am going to get to in a minute.

THE COURT: But your 325 rule is much different from your record keeping rule.

MR. BEEBE: That's right. It's an absolute rule.

THE COURT: 325 is mandatory.

MR. BEEBE: Mandatory by Congress.

THE COURT: Whereas they could carry the bad record keeping for quite some time.

MR. BEEBE: I don't know how long they can do it.

THE COURT: What is it in this case that made

it unreasonable?

MR. BEEBE: I think we have seen they were on restrictions in April of '68. Things got worse afterwards. They weren't placed on restrictions again. In January, the end of January 1969 the plywood comes in to cover the hole and no affirmative step is taken simultaneously or before to fill in the basic problem. As long as those record keeping problems continued the capital problem was worsening, was not being repaired.

The money was being drained from the company by the loss of profits. And the money that was being drained, your Honor, was our client's money. They were entitled to the protection that Congress had mandated for them. They were entitled to 325 protection and to the record keeping protection. There has to be some purpose fot those rules.

Sure you can say a guy has more discretion to cure record keeping problems than to cure a capital problem, a little more time. But there has to be a limit.

THE COURT: All right.

MR. BEEBE: I was going to talk about Mrs. Anna McDonnell for a minute. The testimony from her

deposition and the other evidence regarding her transactions show as of this point that she was not told of the true condition of the company; that the exchange knew of her age and relationship of trust so open to abuse that existed between the son and the mother and that the exchange did absolutely nothing to assure that she was not bilked. The exchange learned within hours after Bishop's command that Mrs. McDonnell had agreed to add to her subordinated account, a time period which allowed for no reflection on her part and no investigation by outside financial advisers acting on her behalf and in her interests.

This morning Mr. Brooks summarized or said he was summarizing her position from her testimony. I have some trouble believing that Mr. Brooks listened to the same reading that I did. Page 211 of this case, I'm not citing from the deposition but citing from what is in evidence here:

"Q How long have you had anaccount at McDonnell & Company?

"A Quite a while back.

"Q Have you ever subscribed to any business advisory service or letter?

"A No.

"Q Did you ever read the financial sections of the newspapers?

"A No.

"Q Have you ever read newspapers to detect any articles about McDonnell & Company?

"A What do you mean?

"Q At any time.

"A I never saw anything about McDonnell & Company until they were in trouble.

"Q When did that first come to your attention that they were in trouble?

"A The newspapers, when there was trouble with McDonnell & Company then I read. When McDonnell & Company were in real trouble I read very little of the newspapers.

"Q Can you tell me what Murray said to you at this time?

"A I believe -- no, I can't tell you.

"Q Do you recall the substance of what he might have said if you can't recall the particular words?

"A I presume it was expansion, for expansion.

"Q Did he mention the New York Stock Exchange capital rule?

"A No.

"Q Did he tell you anything about the condition of the firm at that time when you first put your securities into the firm?

"A No.

"Q At the time you did that did you realize your securities would be at the risk of the business: should the business fail your securities would be available to the creditors of the firm? Do you understand the question?

"A No, I don't understand what he means by I woudln't consider it a risk.

"Q You did not?

"A No."

THE COURT: Didn't she at some point say, when you put your money in a brokerage business there is always risk? I just was looking through my notes.

Let's come to the high water mark against your position, which was on cross-examination, where she said she assumed in 1969 things had worsened and they needed the money.

MR. BEEBE: I am going to read from that right here. I think it's answered by the witness herself in absentia. Page 216:

"Q Did you ask any questions about why your money was needed now for the firm?

"A Actually, no.

"Q Do you recall any explanation being given by Murray or anyone else as to why your money was being requested?

"A I think I mentioned it earlier. Expansion.

"Q Anything else?

"A No."

What did she mean by risk? Let's talk about that from her very words, becasue a lot of territory was covered in her deposition, which hasn't been mentioned here, right on this very point.

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"Q Was it a meeting between you two?

"A No, a telephone conversation.

"Q Do you recall whether he told you that McDonnell had any problems at that time?

"A I don't really recall.

"Q Do you recall whether he told you that McDonnell was in violation of the New York Stock Exchange capital rule at thattime?

"A No.

"Q He did not tell you that?

"A (Shaking her head no)

"Q Did he tell you the firm had record keeping problems?

"A No, at that time.

"Q Did he tell you anything about the condition of McDonnell?

"A Not that I recall."

Now, the risk question, page 223, and this is of this trial transcript:

"Q The third paragraph of the letter says in part if subordinating your account subjects you to these risks. The question is were you aware of any unnecessary risks in subordinating your account at this time?

"A I wouldn't use the word unnecessary. There were risks.

"Q Will you tell me what they were?

"A Thr risk that I might lose all my money.

"Q Were they explained to you by anyone?

"A I knew enough.

"Q Were there any risks, any more risks in 1969 than there were in 1962 or 1965?

"A Wouldn't you know that for yourself?

"Q The answer is yes?

"A Sure there were more risks.

"Q Can you tell me why the risk was greater at this time?"

And this goes to what she thought the risk was that the questions were addressed to:

"A No, the risk was greater because I was giving everything I had."

If there is any ambiguity in that, let me turn to the next page:

"Q Were you aware of whether an investment in McDonnell in January of 1969 was any riskier than it was in 1962 or 1965?

"A Yes.

"Q Was it more risky in 1965?

"A Yes.

"Q Do you know why that was so?

"A Because it took everything I had. The risk?

"Q To any investor?

"A I can't answer that because I don't know anything about that.

"Q So then you didn't have any knowledge for a risk for an investor generally in the firm of McDonnell & Co., Incorporated in 1969 as compared to 1962 or '65?

"A I wouldn't have known anything about the investors in the company."

The risk she is talking about was the risk of the proportion of the investment she was making. She was putting in more in '69 than in '62 or '65, so the risk was greater. That was the risk.

THE COURT: She says it's always risky to lose all your money. Later on, somewhere in he transcript, she had some statement roughly like my notes reflect. That things had worsened in '69 and they needed it, or something like that.

MR. BEEBE: The answer to that clearly is, and the question you addressed to me this morning, sir, in the middle of Mr. Brook's argument, seems to me pretty clear. Let's say I say to a potential investor, look, things are worse now than they were before but I neglect to tell the poor fellow all the things that are so terribly worse. The burden is on them to show.

They were talking about all these but for argument, why didn't the investors get on the stand? The burden is on them to show if they were told that they wouldn't have made the investment.

THE COURT: Mr. Beebe, if an imperfect world it seems to me and true it is that this is apparently

an unhappy situation involving an elderly mother of a substantial brood whose husband left her a sizable estate. But how much more -- put it another way: This lady says she knew things had worsened. She knew she could lose all her money and she knew they needed it. How much more can you demand of a person knowing that their investment is in risk?

The company has worsenee and she does lose all her money. There comes a point where a person certainly is on notice. I don't know where the statement from Jim to her that he tried to tell her not to do it came in. I think that was some time much later.

MR. BEEBE: No, I would have to say that he told virtually simultaneously or just a few minutes later or a few hours later. He wrote a letter to her to that effect. But Jim did not know what the facts were. She didn't know what the facts were. Sure, she knew things were worse.

THE COURT: Was she then charged with finding out how much worse?

MR. BEEBE: I don't think that is the way the securities laws read. Mr. Stein would have the court believe there is some sort of protective investor obligation to go forward and do a thorough investigation. He would turn the securities laws on their head. As I previously stated, the Affiliated Investors and the other cases are now all the law of the land, from the Supreme Court down. There is a duty to bring to the attention of the investor enough of the precise material advantage to put them on notice. If they acknowledge that things were worse than they were before, which is very vague, certainly almost the contrary of what she testifies elsewhere, and that knowledge certainly was not bringing home to her the fact that there had been violations here, the fact that there had been record keeping problems, things that the exchange found constituted violations. They were losing money. That was not brought

home to her. Partners were withdrawing. No steps were taken to bring that home to her. No evidence has been introduced. Maybe it will be later. I would like to hear it, that some procedure was set up to make sure she got this information.

I submit, sir, that the jury could well find that she was not on notice, in fact, that this information was concealed from her, that the New York Stock Exchange actively aided and abetted in the concealment, and that there was a material wrongdoing committed on Mrs. McDonnell. I have other case law, I can cite it, as well as within our memorandum, and I would like to allude particularly to the Titan group case.

THE COURT: That case doesn't help you. I have read it over the lunch hour.

MR. BEEBE: The Affiliated does. I will start with Affiliated.

THE COURT: As I understand the Titan case, that says if you have a non-disclosure you can work then to something material.

MR. BEEBE: I think it also goes to the reliance point.

THE COURT: The chairman of the board there wanted to pick his company up for a lot of reasons. In this

situation she knew that things had worsened and she wanted to keep the family business going, that was material to her, and she already knew things were worse.

MR. BEEBE: May I say, sir, if you will look at the transcript that I have just cited, she was asking these questions because there was more of her funds going in. She was told they were being brought in for expansion. It happened before. It is quite important, the fact that she had gone in before and gone out again. She was lulled into a sense of safety.

If I am to have any voice for tomorrow I will have to move on. I go to the knowledgeability letters. The fact that the exchange required them later has been clearly shown. It was like locking the barn door after the horse was stolen. The major capital contributors, our clients, were already separated from their funds by that point.

I am going to start going to go into the legal areas of some of these factual matters. One is the omissions case, and that is why the Titan group is cited by us. It says when you have an omission then causation is an important factor. It is the same proposition as the Affiliated group in the Supreme Court.

THE COURT: Titan says you got to look to materiality.

MR. BEEBE: You have to see whether there is a causal connection. That is a burden of the jury. I am going to prove to the jury the fact that she was not told these things could have led a reasonable man who had been told these things to not make the investment. We can presume that she is a reasonable person.

THE COURT: If Mrs. Anna McDonnell had been told any one of your six items do you think that would have made a particle of difference?

MR. BEEBE: Yes, all the difference in the world.

THE COURT: She would have taken $400,000 out?

MR. BEEBE: Your Honor, there were some bets placed or some people talking about bets in the argument this morning. I will tell you what I really think she would have done. She would have picked up the phone before she signed the instrument and said, "Jimmy, I want to do this thing, I am going to do this thing, but all these things they are talking about, are they true? Will you call someone and find out what those those things are about?" And he would have found out about those six things and flown to New York.

THE COURT: Would Murray have told his mother?

MR. BEEBE: I think the knowledgeability letter leaves a lot to be desired. That is why I don't agree with the characterizations from the other side. In this case

what it is supposed to do is put the potential investors on notice. You can call it a knowledgeability letter, a notice letter, you can call it some sort of procedure to put them on notice that some material adverse facts exist and here it is.

THE COURT: This doesn't say a thing.

MR. BEEBE: Then there is a failure. Then it is no good. They would have to do more than that. They got procedures coming out of their ears; they got all kinds of procedure setups. This one should have been done, because it is unfair to the potential investor to be solicited for his funds without being told what was wrong with the company and known to be wrong.

THE COURT: If the knowledgeability letter goes too far you run a risk of a libel case.

MR. BEEBE: What do you do when you have a company that has information about adverse facts. Under the securities law they got to communicate to the potential investors.

THE COURT: That is between the borrower and the lender.

MR. BEEBE: The point is that if the security laws mandate communications of this adverse information, you do run risks that if you are communicating adverse information, but it is wrong, you could conceivably be sued for

libel or slander. But here the adverse facts were true. And, second, the security law mandates that you communicate them. Now, of course, you have to be careful. They keep raising the specter of the Ira Haupt matter. You have to have a measured response. There is the example they cited this morning, Williston and Beane. They got angry for acting too quickly.But, what happened? They prevailed. They went to trial and they prevailed. Perhaps they should have. Perhaps if they had acted precipitously or a little more quickly here and done what we are saying the jury could find would have been a much better action, a more measured response than conceivably they might have faced in someone claiming they did something wrong. That is a problem you have when you have a self-regulatory agency.

THE COURT: Let me keep you on your track and not derail you from your tracks.

MR. DUBIN: Your Honor, Mrs. Margaret Murphy's uncontroverted testimony establish as of this point there was a two-step move to obtain her subordination agreement. One person called her for the account and another person explained the details. Mrs. Murphy, being somewhat less gullible than Miss McDonnell, did ask one question, were there any risks. None at all. Things were being sold for her benefit. She would be protected.

Now, the application that she signed and the other documents that she signed and submitted to the exchange, the exchange's approval on March 6, 1969, the exchange's obligations under Section 10(b)(5) and Section 6, and the controlling persons status, we submit, and the exchange's fiduciary duties, which were also mentioned by Judge Lucas in Dempsey-Tegler, and the protection of the exchange's members by the exchange from liability to McDonnell customers and creditors, the shielding of the exchange's special trust fund, all of these factors provide a direct nexus between Mrs. McDonnell, Mrs. Murphy, the trust, and James McDonnell, on the one hand, and the stock exchange on the other. This nexus point I will gointo in further detail, as I get to the law that we have not covered yet in discussion so far.

Now, if the exchange transmitted their knowledge, the exchange's knowledge to the plaintiff, they have failed to prove it so far. This is extremely important in the case to progress beyond this afternoon. Family membership, without more, does not make one an insider. I repeat, the plaintiffs here were not knowledgeable insiders on the record of this trial so far. They were not at the crucial juncture of each of those transactions listed on the court exhibit; they were not officers, directors, employees or stockholders of the failing corporation. They were not privy, at least

on the record, to those things that would put them in that classification, nor were they informed of the capital conditions which by then violated the Securities and Exchange Commission Act, as well as the rules of both exchanges. The burden on each of these exchanges, which, of course, they have not yet begun to meet, is to show that each of them discharged its disclosure obligations concerning the adverse information in their possession available to them, and that each were somehow exercising their Section 6 obligations or properly by raising funds without taking any steps to warn the potential investors of the material adverse facts, and then there is the question of the controlling person liability. They have to show that they did not directly or indirectly induce the acts that constituted the fraud. I would like to see them try and prove that, but we will see when the time comes. The jury may find from the undisputed facts in evidence to date and from a favorable interpretation of any contested facts that the exchanges devised a plan to permit McDonnell & Company to continue on despite its serious capital problems, despite its violations of the rules. The plan required the exchange to amend, alter, bend, twist, break and tolerate violations of the rules, to play fast and loose with their own prior practices, and to cover up the awful state of

affairs of McDonnell.

The events following the transactions relate to a proposition which the jury may find on the record to date, that the exchanges broke and tolerated violations of the rules to induce our clients to make their investment; second, that the regulatory acts eventually taken by the exchanges should have been taken at a time earlier to avoid the damage to our clients; and, third, the particular concealment of the true conditions in the summer, especially of 1969, the spring and summer, which lulled the plaintiffs into a false sense of security until it was too late.

If I may before moving ahead on the roll over also point out that that is or was a 10(b)(5)(3) violation, an act or practice or course of business which operated as a fraud.

Again, each of the essential elements of liability is present in McDonnell's conduct. First, this transaction was confirmed by a series of letters. The mails were used. Second, the transaction involves the purchase or sale of its security; third, fraudulent practices were involved. Simply stated, McDonnell & Company rolled the debenture over without authority, for under the terms of the trust there were three signators that were needed. Clearly in this case that was not so, and the exchange is responsible

for that, because the exchange on the record to date clearly controlled McDonnell & Company, and I would cite particularly Myzel v. Fields. The nature of roll over is defined in Section 15 of the Securities Act and 20A of the Exchange Act. One has been interpreted as requiring only some indirect means of disciplining or influence, short of actual discretion.

Now, in Hughes, there the court held clearly and said indeed to hold otherwise would be anomalous.

THE COURT: I don't see how you can see these regulatory agencies can also be defined as a controlling party. It is a regulatory agency.

MR. BEEBE: The exchange is an interesting animal. It wears two hats. One, it is a regulatory agency, and the other, it is a controlling party. Here we have someone who acts sometimes with his self-interest hat on, quite interested in the outcome of his various steps. For that half of his he makes a monetary profit and protects the other members of the exchange and shields the special trust fund. I think he should be responsible. And because of the control he exercises and the powers he has he should be held to account, because when he acts or does not act, it is in his own self-interest.

I also point out that there is a duty of inquiry under

Section 6 which pertains particularly to the roll over, and on that I would cite pages 40 and 41 of our brief and the footnotes. At some point whenever we are prepared to have an exchange, I would be happy to have opposing counsel also enjoy reading the citations, and I will have persuasive arguments, and I will be pleased to read whatever they put forth.

But coming back seriously to controlling persons, there are a number of cases that really face this problem of dual capacity. To satisfy the requirements of good faith, it is necessary to show that precautionary measures were taken to prevent the violation. That is why I come to the roll over point, sir, and say the fact that they blythely ignored the underlying trust agreement is no excuse. They should have looked at the underlying trust documents. They should have taken precautionary measures.

THE COURT: What was wrong?

MR. BEEBE: For one, two signatures were needed, and they had only one.

THE COURT: If they saw the trust agreement they would not have seen anything, except that there had to be authority to make the loan and the signatures.

MR. BEEBE: That is important.

THE COURT: And then suppose Lybrand and Ross came

along and says, "This is authorized."

MR. BEEBE: They misplaced their trust if they put it there. But just take Lybrand for a minute. What was it looking at? Assuming Mr. Menzel, or whatever his name was, actually did what he purported he did, he was looking at a piece of paper that didn't have any recitation that Mrs. McDonnell or Jim McDonnell had authorized. It did not say, "Pursuant to the authority delegated to me." It didn't have two signatures. On its face it was fraudulent and unauthorized. Now, Lybrand may have made a mistake. I don't deny that. And the exchange might have mistakenly relied on them. But who is responsible? Where does the buck stop. Let them go after Lybrand.

THE COURT: Why didn't your client go after Lybrand?

MR. BEEBE: Primary responsibility can't be shunted off onto an agent.

THE COURT: Let me ask you, Mr. Beebe, let us assume that Murray committed a fraud here, who is primarily responsible, Murray or the exchange? Suppose Murray lied to his mother.

MR. BEEBE: Under Section 6 the primary responsibilit lies with the exchange. Murray does not have any Section 6 responsibility. The primary tort feasor here, if there is one in this case, and that is what the facts indicate so far,

was a fellow named Murray McDonnell.

Now we are talking about a joint and self-liability; we are talking about going against the people who we think were more responsible, or, at least, equally responsible.

Take the example of a car. An owner of a car may hire a driver. The driver may go out and get into an accident. If you are bringing an action, you bring it usually against the owner. The owner is vicariously liable for the agent's acts. The owner did not drive the car. If the owner, in turn, wants to go after the driver, he either impleads the driver, brings a separate action, or makes some other out of court settlement with him. I don't know what they did. You are not compelled to name the driver as a primary defendant.

In this case we say they have these liabilities. There is no compulsory joinder argument that we have to bring Murray in.

Can I proceed a little? Thank you.

THE COURT: You better get to the $79,000 claim at some point.

MR. BEEBE: I think there might have been some kind of misconception so far, and I will try to straighten it out, and that is as to the matter after Jimmy and the other people made their capital investments, what does that

have to do with this case, except as a Section 6 violation, and if it is a Section 6 violation, how are you going to go about proving damage. Well, the Sloan case, Judge Lasker's case, says you have standing even after you made your investment, and I think we have gone to some further steps to prove damage, that we would have blown the whistle and not been put in a false sense of security and given the hundred-day notice in time, some steps in that direction. But the main purpose of the evidence after our people came in is to show what should have been done earlier and to show the pattern by the exchange, an unbroken pattern by the exchange of not enforcing the rules, which is all relevant to show what happened before our people went in. It was all part of the same package and parcel, and there was reliance on Mr. Haack's statements that there would be a normal application of the rules. That is what happened to our people. And after Mr. Schuette and Mr. McElroy examined McDonnell's files, they found things that were suspect. They met with the officials from the exchange and the company and explored possible restrictions to be recommended to the Board of Governors.

THE COURT: Let me take you on the other side, back to the ranch kind of thing. When did Mrs. Murphy have this back fence talk?

mmh15

MR. BEEBE: I believe that was in the late spring, May or so.

MR. BROOKS: She testified in the early spring.

THE COURT: She was told that things were not so good down at the company.

MR. BEEBE: I want to correct that. At one point in the record, and I don't know whether that had been gone into too quickly by Mr. Brooks, whether he was saying it, or maybe it was Mr. Stein said she did nothing all summer. It is wrong. Here is exactly what she did, she called Rick Olney and tried desperately to find out what was going on.

MR. STEIN: The transcript is page 106, and Mrs. Murphy testified that the conversation was early spring of 1969. That is lines 20-21.

THE COURT: She could not get Rick Olney, and it reinforced her belief that this gossip was true.

MR. BEEBE: Yes, and then Jim came in and so on.

THE COURT: Why didn't the hundred days come in there?

MR. BEEBE: It happens to fit in with the next area I am going to talk about. Early spring. Can you take judicial notice of the fact -- I believe it is true, that spring starts on April 21st.

MR. BROOKS: March 21st.

MR. BEEBE: I am glad that is corrected. March 21st.

mmh16

I don't know when she learned exactly.

THE COURT: In the first month of spring.

MR. BEEBE: March or April some time, and she tries to call Rick Olney and nothing happens. Let me first bring it out here and say what it is.

THE COURT: Which would mean by July. She knew she could either get her money back or the company would go bust in giving it to her.

MR. BEEBE: The argument on the other side puts them on the horns of a dilemma. On the one hand, they say these violations did not continue, the violations were cleared off, that everything was hunky dory at the company. At least, I heard them start at the beginning to argue there was a temporary violation of the company back in January, that it was then cleared up, and then in the summer things got worse. If that is true, then they could have gotten out; she could have given her hundred-day notice.

THE COURT: She didn't.

MR. BEEBE: Two reasons, one, because they had been assured that the company, she had been assured that the company was in fine shape. Sandra told her something to the contrary, but there was no final evidence yet. Point number 2, the company and the stock exchange were engaged in a concealment at that point. That is what I think the

evidence shows, and I am sure the jury could find the true facts,for the very purpose of making sure that people like Mrs. McDonnell did not ask to get out, because they could ill afford, the company could ill afford to lose these people at this point. That is why in coming up to April 1st, Mr. Schuette and Mr. McElroy are recommending restrictions and they were not imposed.

THE COURT: Would you urge upon me or upon the jury that a person who is told the company is in bad shape and cannot reach an officer after making attempts to do it and can't do it, that that person can assume that everything is hunky dory?

MR. BEEBE: No. As I remember her testimony, it is to the effect as she learned how bad things are, especially after Jim came--

THE COURT: When did Jim come in?

MR. BEEBE: About June or so, if I can remember. Memorial Day weekend, the end of May. Then she tried to get out. Do you remember all the testimony, sir, about how she was told there was no choice. She tried. And I also don't think laches applies here in a legal sense. I don't think if they are pleading the statute of limitations here, that that applies.

THE COURT: What the stock exchange is arguing is

showing a state of mind to put the money in and help the company out.

MR. BEEBE: All her actions are to the contrary. They can argue anything they want.

Now, here we have April 3rd. McDonnell & Company starts to pressure the exchange for special treatment. McKay claimed at a meeting with Fred Stock on the exchange officials that McDonnell had received special interpretations to avoid 325 violations at the January 29th meeting.

For instance, complete exclusion of dividends, shorts, income tax refund claim, stock record differences, et cetera.

Now, on April 7th McKay threw down the gauntlet. The last line of that memo, short memo of that day says, Exhibit 52, "The company would contest the restrictions."

Was the stock exchange tough on them or did they nuckle under? Schuette's handwritten note dated April 17, 1969, states without any explanation, and I think the jury could draw the worst inferences, "Meeting of Bishop, Stock and Murray McDonnell, no restrictions imposed."

Were the voluntary restrictions back in January adequate? Were the company's capital or operating conditions suddenly improving markedly or is the inference we believe the jury can and should draw at this point, was the exchange

simply protecting its own pocketbook? Because what did the exchange do then? It engaged in a gradual liquidation which, as I will show, the evidence before this court and jury will establish was much to their best interests when they were wearing their nonregulatory hat, and that's exactly what Exhibit 86 shows happened.

The Haack memo is an admission that they took off their regulatory hat as far as McDonnell & Company, Dempsey-Tegler and Blair were concerned. They didn't have enough money in the till or they didnt' want to have that kind of claim against them. They took off their self-regulatory hat, put on their self-interest hat, p the other hat in the closet and didn't engage in any valid measured response as far as McDonnell & Company is concerned thereafter.

Let me just cite the evidence here. By the end of April it is not a question of whether McDonnell is over the 2,000 statutory limit but how far over? Taking any reported date in the evidence so far and any way you want to cut the pie the jury could find from the exchange's own analysis, and I will cite some examples. They can cite others in their summation or other evidence if something can be introduced to the contrary.

As of right now we have numbers like 5,525 per cent

rdh3

as of October 30, 1968, Exhibit 28 the examiner's final report. 3,825 per cent as of January 30, 1969, Exhibit 26. 2,000 --

THE COURT: That's cured by this money.

MR. BEEBE: I don't believe so, sir. Let's take the next one. March 27, 1969, 2,920 per cent. In fact one is hard pressed to find an internal exchange analysis, and I am not talking about McDonnell & Company's own bloated figures, if you will, but the exchange's internal documents which they were keeping very close to the vest, very hard to find one below the 2,000 per cent limit or any support by the exchange for the figures coming out of McDonnell & Company. It is hard for anybody to believe those figures after a certain point but the exchange kept apparently relying on them or at least they said they would.

One use of a lower figure by the exchange sticks out rather conspicuously, however. On April 28, 1969, after all the analyses and figures just mentioned were prepared by the exchange Mr. Newman testified right here, talked on the phone to Joe Barton at the SEC, "What's the story?" asked the SEC man. Newman answered only that McDonnell's own ratio was 1,947 per cent. That's Exhibit 55. Mr. Newman conveniently omitted the violative ratios that the exchange had already found. This was Newman talking on

April 28th.

Why was he doing this, concealing these facts from the SEC? Why weren't our clients told about the unicorn that appears on the scene? Why weren't they told that the rules weren't being enforced? Because their money was needed.

Newman believed that nondisclosure was the offer of the day; that the jury can find from all the facts and circumstantial evidence that the exchange followed the same pattern in dealing with our clients as they did in dealing later on.

The uncontroverted evidence in the record shows that the exchange began drafting charges against McDonnell late in April but then, again without explanation, at least a decent explanation, they backed off. One could conclude from the evidence so far that the exchange then embarked on an undisclosed program of liquidating McDonnell & Company and reducing the claims against the exchange's trust fund. Branches were sold, proprietary positions liquidated, accounts transferred. And in six months the company had gone from 26 branches and 5,000 customers to three branches and I don't know how few customers.

Maybe Mr. Stargatt will tell us tomorrow if he has anything to testify about. I don't know what his testimony will be. This liquidation made no provision

for capital contributors. That's the important point about that silent liquidation program going on. Everyone was provided for, others were provided for, not our people as they might have been if there was a real liquidation at that point, where everyone who is a creditor could be provided for. We weren't told there was a silent liquidation going on. I don't think Jim knew. Ghere was no testimony he knew or that any communication was made to him.

The exchange used their money, as I said earlier, to buy time. By doing it on a unilateral basis it avoided any attempts by our clients to withdraw their funds.

Note that under the subordination agreements they could withdraw on a hundred days' notice provided the company wasn't in net capital violation.

Now, that then brings us to the trust fund which ended up paying seven or eight or nine million dollars. It is a little unclear but maybe we could get that cleared up, to the public customers. The jury could fairly conclude that the claims could have been very substantial. And higher if the exchange could properly and promptly discharge its regulatory duties and put the firm out of business instead of bowing to the exchange's self-interest position.

THE COURT: Isn't that a discretionary fund? They don't have to pay a penny if they don't feel like it.

MR. BEEBE: There are two answers to that. If the exchange, as you will see from Mr. Haack's testimony, his memo about what had happened, the exchange was terribly interested at that time in "public confidence." That's another euphemism. They were terrified they were going to lose business. They were terrified that people were no longer going to deal with them because they were in such shaky condition. One way to keep people there is to back them up when a company goes under, to pay them out of the trust fund so the exchange can say to the public, don't worry, if anything is wrong we will cover you.

That's okay as long as you have little companies. But once the big one comes along you no longer want to say don't worry because it is going to cost you. It cost them eight or nine million as it was. Ifthere were ten times as many customers when theywent under, that's eighty or ninety million.

What was the exchange interested in when it set up the trust fund? It was really interested, as I see it, in shielding itself from direct liability. It kept calling this a discretionary trust fund but I wonder how discretionary it was if a public customer made a claim directly against the exchange and brought their lawsuits as class actions or otherwise against them. The Pacific Insurance simply is

another way of insuring the exchange's actual legal liability. I think the trust fund may have been a very fancy footwork operation to get themselves out of direct liability by telling people you got some problem, go over to the trust fund, they will take care of you. Instead of going directly after the exchange. As long as the trust fund covers you, that's fine. But it didn't cover our clients.

Now, we have a conflict of interest of the exchange in January, 1969. If McDonnell is put out of business, if it notified capital contributors about the gravity of the situation, and I mean put out of business within a reasonable time, or at least if it notified the potential capital contributors about the gravity of the situation and scared them off, or if it failed to rescue the company by whatever means possible, the exchange failed to do this rescue job at that point, then the trust fund would pay dearly and the members of the exchange would be hit right where it hurts, in their pocketbooks.

Arning reaffirms that the exchange "never dreamed of suspending anyone if the trust fund culdn't cover them." That was from the transcript at this trial 1427.

I have gone over the major elements. I could also talk about the lettered stock, about the exchange enforcing the rules and then suddenly saying that lettered stock had

rdh8

value, drew dollar signs out of its ears. I don't know where that came from. Maybe lettered stock was a unicorn.

THE COURT: Let me know about the 79,000.

MR. BEEBE: And I could talk about press releases and a number of other areas that I think we have covered in one sense or another.

The 79,000 I find much bolstered by the Sloan decision by Judge Lasker because what he seemed to say, as I read him, is that everyone who is in the exchange community who is not a general partner, someone who is in the active daily operation of a company, is protected by Section 6. He didn't speak of the facts in front of him, did not pertain to when a person comes into the firm.

As far as I understood the facts there, the Section 6 protection continued after the man was in the house. The 79,000, that preferred stock had been in existence for some time. It still has standing to press a Section 6 claim unless it is an insider. I don't think the stock or that particular trust interest qualified as an insider. Perhaps they can prove otherwise.

I think on the record to date the trust was not an active participant in the company's affairs. In fact, that perhaps is a very small element in the terms of control and operation of the company if at all.

So there I have a Section 6 claim and there I don't have a 10(b)(5) claim. And the Section 6 claim really comes down to the measured response of the exchange to the problems it was facing and whether the company, if the stock had been sold or if the trust had requested approval from the exchange to transfer the stock to someone it could have done so in time and at a value, at a face value of something approximating before the exchange's lack of enforcement brought the company to its knees.

Mr. Brooks mentioned, I believe, that this is restricted stock and requires some approval before being transferred. Be that as it may, it is still possible to transfer. Still possible to have some value. Still possible to render to the company for redemption if need be, to seek approval to do these things if possible.

So there was some value to that stock and I believe the value can be presumed to be the face value and the company could have been presumed to have adequate assets, based on Mr. Brooks' statement and the evidence so far that the company did have a net worth of some sixteen million dollars in January, 1969, at least according to some of the exhibits here.

I won't quarrel with that for these purposes. I think that's the sum and substance of the Section 6 claim.

rdh10

There are many different kinds of families. I think the court can take judicial notice of that fact, just as there are many different kinds of people in this world. Most people I hope are honest. Not all of them. Most grown men would protect their mothers and not ask their mothers to do something that was not in a mother's best interest, but not all grown men would do that. Some familieis are close, some divided. And this one, the McDonnell family, was so big, so diverse that the different elements had different interests and had much separateness.

There is no blood exception to the securities law. There is no statute that I know of, and no inference can be drawn from the rules of evidence or from common sense, your Honor, that one brother will tell another brother the truth. There is no securities law provision that says that a mother qua mother is a partner in her son's operations.

A sister is not an insider. Knowledge must be established from facts. That's the exchange's burden, a burden they have not even gone to meet.

The family relationship alone by itself without more is absolutely no defense to the facts, the omissions, the frauds, the liabilities, and the proof I believe facts are before this court for the jury, I expect fully submit, to

rdh 11

decide one way or another.

Thank you.

MR. BROOKS: Your Honor, may I make a few remarks?

THE COURT: Yes.

MR. BROOKS: Purely directed at facts which I believe the record shows to be another way.

Mr. Beebe said in the Dempsey-Tegler case there was disclosure and therefore in his case the exchange has a duty to disclose. I think even a quick reading of any part of the opinion in Dempsey-Tegler, which I admit is long and complicated, shows that a gentleman named Bob Peck gave the disclosure in that case to Mr. Hughes Bob Peck was the equivalent of the Tom McKay or the Sean McDonnell at McDonnell & Company. It was not the exchange that gave Hughes any disclosure. They knew a little about him as the subordinated lenders in this transaction.

I think it is important when you analogize to the Dempsey-Tegler case to consider that that firm had its known deficiency of $20,000,000 in September. Mr. Hughes didn't put any money in until the following March.

In McDonnell we have a completely different case because the investors are coming in on the wave of the breaking trouble which only later showed that it was of any sufficient magnitude to cause real concer and the

request for knowledgeability letters.

Mr. Beebe kept talking about violations of 1968. I think if you look at the charge memorandum and the exhibits to that memorandum you will see that all the charges there itemized in schedule form are charges in 1969 starting, or at least known in '69 when the audit comes in. I don't think there is any charge going to a prior period than January 1, '69, except the charge for failure to make a timely audit report in '67 and '68.

I think if you analyze that with any sophistication it becomes an indictment that a prosecutorial staff got up for the purpose of negotiating with T. Murray McDonnell. It was never an adjudication, it was simply a consent and they threw everything they could find in that indictment as prosecutors would do.

Mr. Beebe mentioned a conflict of interest between T. Murray McDonnell as trustee and the firm of McDonnell & Company in which he was an investor and chief executive officer. I think that the will contemplated that conflict when it spoke of the sons of James F. McDonnell leaving money in the firm to support it as capital. It gave authority for the conflict.

Furthermore, Anna McDonnell was an investor in her own right in the firm, so she too had a conflict.

James McDonnell as trustee was an investor of those 797 shares of preferred stock, so in a way everybody has a conflict because they are all trustees and they are all McDonnels and they all have another interest in the firm.

Now, talking about the Lybrand report, Mr. Beebe said we had no business relying on Lybrand. I think the law in Section 6 is to the contrary because it says there is no breach of duty until you know or you should know of a violation. I submit when the Exchange's own rules contemplate that the auditor's report will be the principal regulartory tool, you're entitled to rely on that audit.

The rules contemplate that and the rules have been approved by the SEC and they, too, rely on it because they get it as their X-17-B-5 report.

Now, Mrs. Murphy said, "Don't you trust my family?" I think that's where the Exchange came out, when Murray McDonnell said that I will get more money, and he did get it.

These were professional securities executives. They had been such for years. There had never been a problem with this firm in the disclosure area. They had underwriting after underwriting. They had transactions every day where disclosure was required. They had to know the 1933 and the 1934 Act and they had the best counsel that you could possibly get.

On all of those facts I think it strains the imagination to suggest that the Stock Exchange should take Murray McDonnell by the hand when he deals with these

plaintiffs and say, did you tell them the right facts, Murray? It doesn't have to do that in its everyday business; why should it have to do it in this situation with these plaintiffs?

Mr. Beebe said that the record showed declining profits in 1969. I don't think we have had a report yet on profits in 1969, although maybe you might have inferred from Mr. Haack's letter I don't think it is in the record as to what the profits were. The only thing we have in the record are ascending profits to the end of 1968.

There was some argument that the Exchange should have made them keep their records better. The Exchange doesn't keep the records for the firm. The Exchange doesn't know how to keep records as a member firm knows how to keep records. Some firms keep them one way, some firms keep them another. I don't see how you can charge the Exchange with not making McDonnell keep better records above and beyond what the Exchange was doing. The Exchange couldn't get in there and do it for themselves or do it for the firm.

This, I suppose, is the heart of the free enterprise system when you talk about Wall Street and the New York Stock Exchange and capitalism. I don't see how they could have done any more than they did without becoming, as Mr. Beebe says they became anyway, the controlling person.

If that is what the law is, if this controlling person theory applies to stock exchanges, they darn well better not try to tell firms how to keep their records.

Now, Mr. Beebe read from Anna McDonnell's testimony and I read from some of it this morning. I think there is a difference, though. Mr. Beebe's testimony beginning at page 214 starts off with the question of, "Did you have any understanding at the time you first put your securities into the firm?"

I submit that means 1962. And a good many of the questions thereafter related to the situation of 1962.

My reading was from pages 1042 and 1045 where she said she didn't recall or could not deny that Murray told her about these factors which Mr. Beebe says she should have known about.

Even putting the two of them together, I say, your Honor, when you complete a fraud claim you cannot have any equivocation or ambiguity or uncertainty in your affirmative case as to whether or not you got the disclosure that the fraud case is all about. You cannot do that and make you case by a preponderance of the evidence. You have to be firm and you have to be clear as to what you got and what you didn't. Anna McDonnell has not been able to be that.

Three more points, your Honor. Mr. Beebe suggests that Mr. Newman gave Mr. Barton of the SEC on April 29th or 30th a colored picture when he gave him the firm's ratio. That happened to be the latest ratio the Exchange had, the firm's ratio came in on a weekly basis.

Now, if there is any doubt that the SEC knew what was going on, I think it was corrected the next day when Mr. Barton sent his own examiner into the firm.

Mr. Beebe said that this firm would be entitled to a liquidation that they would get in the Bankruptcy Court. Well, if that were the case, Jim McDonnell surely knew how to put this firm into Bankruptcy Court when he first learned of the problems. Surely he knew that. His Detroit law firm knew that.

I point out 60E of the Bankruptcy Statute which give a preference to customers' creditors and would have made these capital contributors come out where they did, in the back seat, where they belong.

One final point: The automobile driver-owner analogy. There is a big difference. The Exchange did not own the firm of McDonnell & Company, as the owner of the car owned the car. The McDonnells owned the firm of McDonnell & Company, so they were both the owner and the driver.

THE COURT: Mr. Loflin.

MR. LOFLIN: Your Honor, Mr. Beebe professed some puzzlement as to when the Amex was going to regulate and when it was not going to regulate and when the New York Stock Exchange was going to do the regulating.

I don't understand, really, the reason for any puzzlement, and he referred only to an exhibit here which in turn refers to an investigation by Amex into the Margin Department of the Washington office of McDonnell & Company.

The rules of the Amex are in evidence. I would invite the Court, if you feel it necessary -- I think this is a little far afield myself -- if you find it necessary, you will find the margin rules at 460-464; rules on financial accounting and auditing are rules 440 through 445.

I think everyone understands there are stocks listed on the Amex that are different than those listed on the New York. If there is a margin violation concerning violation of stocks listed on the American Stock Exchange, I don't think anyone would be surprised that the Amex would have an interest and take action.

There are times when Amex acts alone. There are times when under its rules it does not act, which is the situation in this case. It is not because we have delegated anything to the New York Stock Exchange.

I think they would be rather surprised to find that they are our agent. It is rather a situation where the SEC has approved our inaction so long as they are assured that the New York Stock Exchange has a rule to cover the situation, and these are the situations that we are dealing with in this case. This has to do with financial situations. The net capital requirements is the focus of this, and in that area the SEC understands the rule of the New York Stock Exchange and the non-rule, if you will, of the Amex.

Examples of the Amex acting within its regulatory authority and acting alone would be the case of Crimmins against The American Stock Exchange, decided in this court by Judge Lasker, affirmed by the Second Circuit.

In that instance it was disciplinary action appealed to the Court by a branch manager of Walston & Company, a firm that belonged to both Exchanges.

The branch manager's job is the same job that James McDonnell had. This man violated the Amex rules in connection with the Four Seasons Nursing Center stock, a stock listed on the American Stock Exchange. The Amex took rather severe disciplinary action and applied severe sanctions against this man, and he appealed to the Court, as he had a right to do.

I cite that as an example of our acting without New York.

Mr. Brooks has referred to the case of J.R.Williston & Bean against Haack. It is also against the American Stock Exchange. We participated in that case. I would describe the actions of the Exchanges there as concurrent, but it is correct, strictly speaking, that New York had the facts first and their Board of Governors acted first and we followed their lead in Williston & Bean and it was up to us in that case to show that that was justified and we were ultimately successful along with the New York Stock Exchange based on the particular facts of that situation.

Now, what do we have here? We have the Congress in 1934 concerned with abuses in the securities industry

and they set up a whole scheme of regulation which, hopefully, has some logical coherence to it.

The SEC was given an absolutely vital role to tell the Exchanges what they should do, keep an eye on them and to keep an eye further on the member firms. They have done this. They don't expect us to duplicate each other's efforts. They do expect member firms to be regulated.

They are concerned with losses to public investors. There is no doubt, even from the record in this case, that the SEC does fulfill its responsibilities. The Exchanges do not go very far off on their own without checking with Washington and keeping them informed.

We are trying to fulfill our role under the 1934 Act and we do that by obeying the rules which we have submitted to the SEC and which they have approved. They hold us to those rules. They do not hold us to rules we don't have.

That, it seems to me, is the problem that we have in this case. We are being asked on hindsight why we didn't behave in a way that our rules didn't require us to behave. In other words, why we didn't have a rule that protected them.

Under the cases that is a matter for the SEC and not for the Federal District Court. The Amex followed

its rules, and in following it we believe we should be dismissed from this case.

MR. STEIN: Your Honor, I have nothing further to add.

MR. BEEBE: Just a very few points, sir, which are responsive to a few things raised here.

In Hughes versus Dempsey Tegler Mr. Brooks said that Bob Peck, apparently a figure involved in that, made the disclosures and he is like Mr. McKay here. The point is that Mr. McKay didn't make the disclosures.

The statement that he mentions that the charging memo is merely an indictment that we got up for negotiation, it is an admission. They got it up. It is their admission, their statement of the facts and it is actually the one that was consented to. The one I introduced was not the initial one that came in as a kind of charge. This one that was signed by all parties.

Now, the will. Senior Mr. McDonnell's will didn't speak about the funds would be kept in the company, it was could be kept in the company. No matter how bad things are, the trustees are using their discretion if they kept it in when they knew or should have known that the company was going under.

Lybrand, I guess he is still saying that the

Exchange didn't know or suspect. I think the standard is know or suspect under Section 6 the facts. Lybrand certainly knew and suspected. If they are going to rely on them, they certainly get them good and bad, with warts and all.

Jim's testimony was that they were losing two million dollars a month, as I remember.

THE COURT: That is in the summer.

MR. BEEBE: Yes.

THE COURT: I think you stated earlier --

MR. BEEBE: $700,000 I mentioned.

THE COURT: As far as you were concerned this is no longer a Section 6 case after Jim gets in the act, which I take it is the Memorial Day weekend.

MR. BEEBE: Sometime after that. As soon as he becomes fully apprised of things, it becomes more of a relation of a bad course of conduct case as far as our evidence is concerned.

(Continued on next page)

About loss of profits, I believe there is ample evidence they were losing profits at a fast clip and losing money. They weren't getting any profits any more. This rich money tree was wilting. Maybe it was being eaten by the unicorn.

Now, on Anna's testimony certainly we have disputed facts for the jury. A lot has come out about what the SEC approved or didn't approve. Mr. Loflin seeming to imply that the SEC thought everything that was happening at that time was just marvelous.

I would like to say there are public reports that have been printed and that are public documents, and they are the subcommittee -- a Study for the Special Subcommittee on Investigations of the Committee on Interstate and Foreign Customers of the House of Representatives, July 1971, entitled "Review of SEC Records of the Demise of Selected Broker-Dealers," known colloquially as the Demise Report.

There is also the study of Unsafe and Unsound Practices of Brokers and Dealers, with a report and recommendations of the Securites and Exchange Commission, December 1971. That is known as Unsafe and Unsound.

There is a report called "Securities Industry Study" of the Subcommittee on Commerce and Finance of the

House Committee on Interstate and Foreign Commerce, October 4th, 1972.

Finally, there is the very detailed study, building on these and others, of the securities industry, which involved hearings before the Subcommittee on Securities of the Committee on Banking and Housing and Urban Affairs of the United States Senate, which contains a report on self-regulation in the securities industry, and an appendix which I would --

THE COURT: Mr. Beebe, what are you urging these reports on me for?

MR. BEEBE: Well, I submit that in the summary, as I heard it, the argument made at the end here and also a little earlier, there is some implication that seems to be floating in from outside the evidence in the case so far that there was some blessing, laying on of the hands of Washington as to all that happened.

I submit it is to the contrary. There was no approval for what happened here.

That concludes my remarks, your Honor.

THE COURT: We will take about a five-minute recess.

(Recess)

(In open court)

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THE COURT: Now, it is late and everybody is, I'm sure, tired about the ears. I am going to dismiss as to the American Stock Exchange. I will put my reasons on the record in the morning.

I am going to reserve decision as to the New York Stock Exchange.

I am also going to reserve overnight as to McDonnell & Company.

Now, in terms of witnesses in the morning, I would think that alternatively the Stock Exchange ought to be prepared with a witness as well as McDonnell & Company. In other words, if I concluded it should not be in the case, obviously McDonnell would have to go forward with whoever it chose to put on. So guide yourselves accordingly for the morning.

Mr. Stein, in other words, if you have witnesses that you are going to call I would suggest that you be armed with one.

MR. STEIN: It had been our intention to put on our witness tomorrow morning as the first witness in any event.

THE COURT: Very good. That solves that problem.

So I will see all of you at 10:00 in the morning. I will see some of you at 10:00 in the morning, I should

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more correctly say.

MR. BEEBE: I don't know if it is necessary, but with all due respect may I note my exception for the record?

THE COURT: Certainly.

(Adjourned to May 13th, 1975, at 10:00 a.m.)

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MARGARET MARY McDONNELL MURPHY, et al.
vs.
McDONNELL & CO., INC., et al.

May 13, 1975,
10 A.M.

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(In the courtroom in the absence of the jury.)

THE COURT: Good morning.

MR. BEEBE: Good morning, your Honor.

THE COURT: Mr. Beebe, let me address some questions to you which have troubled me.

You say that Exhibit 86 is the capstone of your proof?

MR. BEEBE: Yes, sir. I think the jury could so find.

THE COURT: Well, tell me what the jury could so find from Exhibit 86.

MR. BEEBE: I think a reasonable man could infer from the pattern of inaction by the New York Stock Exchange, freighted with a great deal of information about the capital and operating problems, the bookkeeping problems, the delays in ability to complete their audits; their inability to make stock record accounts; that the exchange with all this knowledge and all the recommendations of their examiners to take action failed to act because it was

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protecting its own. It was engaging in abnormal application of the rules in the case of McDonnell & Company and two other companies, Dempsey-Tegler and Blair & Company without disclosing -- well, there are two parts that are wrong with that. One, their abnormal application of the rules, and we are entitled to normal application of the rules, and we are entitled not to have James McDonnell, who is here also this morning, who was trustee of the trust that was involved, personally involved, and his mother may not be here --

THE COURT: No, stick with 86.

MR. BEEBE: Right.

The point I am making, sir, is that their money was used to allow the company to stay alive. They were not given the quid pro quo which was normal application of the rules which the statute and Sloan and Hughes and Congress intended to give them as their protection.

They also -- and I think 86 helps to prove this is the end of the line, is the final note in a long pattern; it also proves, or, at least, the jury could find that the exchange had suspended enforcement of the rules and had not told them before they made their investment that this plan, this particular program for the good of the other brokerage houses was in place.

Now, it is one thing to have to discover that you have a unicorn in your garden and to act accordingly, but it's quite another when you have such a peculiar event going on that is a material -- and I think a unicorn is a nice friendly beast, but I would have to say that this is an unfriendly tiger that they discovered, and this is the proof of it, in their garden, and they did not tell the investors that they had suspended enforcement of the rules or were making abnormal application of the rules.

I think that is just a polite way of saying they were not applying the rules for McDonnell & Company, and the jury could so find.

That, in a nutshell, sir, is the major importance of 86.

THE COURT: Now let's go right to 86.

I think that you are looking at the bottom of the page that has a heading "Practical Self Regulation," and under that the language: "The exchange found itself facing situations where normal applications of the rules could have," etc., etc.

Is that where you are looking?

MR. BEEBE: And the carryover where it says there were three member organizations where that normal application of the rules could have had those effects, and there is I

think a clear indication that a jury and any reasonable man could draw the inference that in the case of McDonnel & Company they did not have normal application of the rules.

I am also looking at the summary on the first page which we went through with Mr. Arning on Friday and his testimony along those lines.

THE COURT: Now, when do you contend on this record that a jury could find that there was an abnormal application of the rules? When is the first time that there is support for a finding of an abnormal application?

MR. BEEBE: I think that if you hark back to the recitation I did yesterday, the facts in evidence, and you look at this exhibit which is talking about a three-year period -- there is no question that this exhibit goes back that far because it says --

THE COURT: No, I know that. I have already thought about that possible inference from that exhibit, but I reject it, because we have a specific record of what they did. So the question is when on this record do you have the first arguably abnormal application of the rule?

MR. BEEBE: Yes, sir.

First may I say that I believe it is fair to say that a jury could infer from this plus the record, from 86 plus the record --

THE COURT: I would think it would be improper for them to infer that given the fact that we have a specific record of conduct and we have a profitable company into October of 1968. I do not think we have any proof whatever of what was being done prior to that time except a period of restrictions as to which there is no showing that it was an inappropriate ruling.

Now, where do you contend the first abnormal application is?

And, Mr. Beebe, I want specificity here because we are getting down to an area that may very well determine which way I rule on the stock exchange.

MR. BEEBE: Yes, sir, and I have specificity in great detail.

I start -- I do it from recollection -- with the fact that after 17 days of well placed restrictions that the exchange puts on and says they should be kept on for the foreseeable future, it suddenly lifts them. It says you shouldn't go into expansion; the company dares go into expansion immediately thereafter.

It says that you shouldn't have more registered agents; more registered agents come in.

It says you should warn people specifically, and directed specifically McDonnell & Company that you should

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not go into a computer conversion without great care and caution, and it's a very dangerous animal; and that's exactly what they do; they go into computer conversion.

They promise that the computer conversion, that it would be completed in the July 4th weekend, and it is not completed, and it is not completed, and it is delayed and delayed; and then as you go into the fall, and then on grounds of specificity, sir, you find fails to deliver and fails to receive becoming astronomical --

THE COURT: This period I don't feel to be relevant.

You have a period where a great number of companies are faced with the same problem; the fails are high; the longs are high; the shorts are high, and yet the company is making a profit; the company is in compliance with the capital rule as far as anyone can tell, according to their reports; and so going to the year 1968 I do not see any proof in this record from which a jury could conclude that there was a breach of discretionary duty to regulate during the year 1968.

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MR. BEEBE: If I may continue, sir, because I believe that the jyry could infer from the fact, as Mr. Schuette said and testified, that he was recommending the imposition of restrictions through that whole period.

THE COURT: He said late '68 -- I looked at that testimony last night. He said late '68 or early '69, and he then qualified to say late '68. He said that McDonnell already had restrictions and his recommendation was that there be some more. That was not accepted by anybody else.

MR. BEEBE: That's right. I think you could readily infer from that, from the arbitrage --

THE COURT: Wait. Just stick to the dates. We are getting down here through '68 and everybody is sitting around waiting for the Lybrand audit report to come in.

MR. BEEBE: With all due respect, something happens before that. Something happens before the Lybrand audit. I'm not sure that on this record there is any proof that everyone else in the industry was suffering these problems. In fact, I'd again refer to 86, which says there were only three companies that they had to do something special about.

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So it was not something that everyone was suffering. McDonnell was suffering it and McDonnell was in a special -- especially bad situation.

THE COURT: The very first page of 86 says "105 firms at one time or another were on exchange restrictions because of severe paperwork problems, and 139 firms were monitored by the exchange in 1970 under the early warning surveillance program because of financial problems."

These are general problems, as I see it, on this record.

MR. BEEBE: I see that, sir, and I brought that out from Mr. Arning. It seemed to me 86 went on to say there were three that were particularly bad.

THE COURT: I am saying to you what is the first time that you claim there was an abnormal application of the rules to your client?

MR. BEEBE: I have said that they should have reimposed on restrictions and that it was abnormal that it was not reimposed. In fact it was very suspicious it was not reimposed late in '69, when Schuette, the man on the scene, the coordinator in charge of any operation was recommending it. Why was he recommending it? There was arbitrage problems. Those

arbitrage problems the company itself said could not be solved within the language of rule 325, so they went outside the language. The company said please solve this for us. The exchange lower people, doing their job, said we have to go to the SEC to get permission to do this and McKay said, oh, boy, let's do something else. And then the examiner notes why don't you get more capital?

They didn't get in more capital on this record. What they did was they had an abnormal application of the rules in the arbitrage situation, they had an abnormal application.

When the answer to Mr Bishop's question, compare April to now, I think the jury could readily infer from the records and Mr. Schuette's testimony that the situation was as bad, if not much worse. In fact, Mr. Schuette said so. He said it was deteriorating. Why didn't they reimpose restrictions?

THE COURT: Is that a breach of discretion?

MR. BEEBE: I think if you have a pattern of it and you have an admitsion. This 86 is an admission, sir. You have an admission that we did abnormal application of the rules. Certainly it's not following the rules. It's just a fancy way of saying

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we did not follow the rules. That is what happened here. It happened with regularity. You look at the whole pattern of events and it pushes way back into 1968. The charging memo recites facts going back that far and I think the jury could readily infer, sir, that October 31, 1968, was not a date when all of a sudden everything came crashing down and everything got worse. It was something that had built up. It built up from the failure to convert the computers, the continuing expansion, refusal of the exchange to really clamp down on them or the failure of the exchange or the negligence. I'm not saying this is something heinous at that point that the exchange did but it was negligent. It was quite negligent in not acting and I think the jury could so find, and section 6 mandates action.

You asked yesterday, sir, how long does a guy have to correct things especially when there are operating difficulties. I said there has to be a reasonable standard. You can use the April 8th date as a frame of reference, the later dates as a frame of reference. But they didn't act and they should have acted.

The record shows they weren't acting at that point and they certainly weren't acting in January when they should have imposed operation controls and

they didn't do so.

THE COURT: Let's go to January. They immediatly in January, upon finding a capital violation, demanded more capital. So there was immediate action there. No question about that.

Do you feel that it was a violation of the discretionary duty to wait on imposing or requiring voluntary restrictions by McDonnell until the exchange examiners had themselves ascertained what the picture was, because the Lybrand audit only gives finances. It doesn't give a status report on the inside of theoperations of the company. And until you get some idea of what's going on in the company you cannot intelligently regulate.

So upon receiving the Lybrand report a number of SEC people go in from mid-February to mid-April and make a study of the company and issue a report.

MR. BEEBE: Examiners go in, not SEC.

THE COURT: Examiners go in and issue a report, stock exchange people.

Now, do you say that they should have been regulating before that report was completed?

MR. BEEBE: Yes, sir, because I know there have been a lot of exhibits that have come in and I'm

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sure you have not had a chance to review them all. I didn't elicit endless testimony from Mr. Schuette as to what transpired earlier because many of the exhibits spoke for themselves.

From those exhibits, sir, it's very clear that the exchange knew a great deal of the operational difficulties well before January. They really had reason to suspect the capital difficulties as well.

You remember Mr. Bishop's little typewritten note on November 7th saying things are deteriorating badly? The exchange knew very well there were operating difficulties at that point. They should have been taking steps to do something about it. They didn't need to wait for any report.

THE COURT: Wouldn't it have been inappropriate for them to have acted without knowing what was going on in McDonnell?

MR. BEEBE: They don't have to wait for an annual report to act, sir.

THE COURT: To impose restrictions?

MR. BEEBE: Of course not, sir?

THE COURT: They have to assure themselves in some way or other, either on the basis of McDonnell's own figures or their own investigation, otherwise they are

acting irresponsibly I would think.

MR. BEEBE: The problem is, sir, they did have reports three times a year that their own examiners gave when they went in. Those reports and the information coming from McDonnell shows a rapidly deteriorating situation. It's not as if the exchange was even ignorant about the situation. They knew before Lybrand went in. They knew this. And they knew that there was a problem. What they did was they put off the day, that's really what happened. The exchange said, let's wait, let's wait.

THE COURT: Let me get some time frame here so that I have an idea.

You say that the arbitrage decision was an abnormal application of the rules and that that was sometime in '68.

MR. BEEBE: Right, August, September. And the failure to reimpose restrictions or do something about operating problems is also abnormal.

THE COURT: How did that affect your clients?

MR. BEEBE: If they had imposed -- before I get to that can I just say one thing about your question if a guy should go in and do a thorough

investigation before he imposes restrictions.

THE COURT: I'm not saying that but I am saying they have to know what's going on in a company before they act. Otherwise it's an irresponsible act.

MR. BEEBE: That's their whole function, is to go in and find these things out.

THE COURT: On this record what is the proof they knew or should have known?

MR. BEEBE: The exhibits and Mr. Schuette's testimony show very clearly the deteriorating situation in '68. The charge memo says the same thing.

Now, even the lifting of the restrictions, sir, I think you will find was a questionable --

(Pause)

THE COURT: Mr. Beebe, let me ask you this: When you get down to saying they should have put on restrictions in the fall of '68, does this record show either what restrictions ought to have been imposed or what effect that would have had upon your clients?

MR. BEEBE: I think, sir, that when you get down to the particular restriction that should hav e been imposed, the particular fine, the particular suspension or act that should have been done, the question becomes for the jury what would be reasonable to

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do in the circumstances? They have all the rules in front of them, they have other acts that the company was subjected to, other controls that the exchange imposed.

From that they can infer that what they should have done is something reasonable and measured, under the Dempsey Tegeler or any testimony one would like to impose, a measured response to the situation.

The point I wanted to make further in respons e to your question earlier, that to simply go out and raise money from our people is not measured, it's unbalanced. It's unfair because it's taking from one, our people, without doing the second half, without filling the hole, without taking steps to actually correct the problems, and they hadn't done it earlier. They hadn't disclosed to our people earlier before we came in that the exchange had embarked on this program of abnormal application of the rules.

A jury can infer that, and I think it's quite clear from the record that that indeed is what happened.

It's the truth.

THE COURT: Well, I am going to continue to reserve decision on the stock exchange's motion. This is a very troublesome question. I shall have to continue to grapple with it because I'm not sure you are

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right, Mr. Beebe. But in the interests of taking our case forward I am going to reserve decision on the stock exchange's motion at this point.

Mr. Stein, I am going to reserve decision on your motion as to Anna McDonnell, which I find to be a very close question frankly. I want to address more of my thought to that.

I would deny the motion as to the other three, and the $79,000 of stock is not addressed to you, so that's not a problem.

MR. STEIN: So I understand.

THE COURT: Let's go forward with our proof.

Bring in the jury.

MR. BEEBE: Sir, before we get the jury could we have an offer of proof as to what Mr. Stargatt is going to say since he wasn't there at the time?

THE COURT: I don't see any need for that.

MR. STEIN: That strikes me as an extraordinary procedure. We have been hearing from witnesses for the last week and a half.

THE COURT: I don't see any need for that.

MR. BEEBE: He wasn't there at the time.

THE COURT: Let's see what the proof discloses.

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(Pause)

. . BEEBE: Sir, I have a citation of authority on the question I mentioned or thepoint I mentioned at the beginning of yesterday's argument about when the defendant puts in evidence. At some point I can give that to your clerk.

THE COURT: Let me ask you this, because I have been considering this this morning. I don't want to get into a long answer because the jury is waiting to come in. But in terms of the sheer failure to regulate, what is your claim of proximate cause as to that prior to the time this is put in? Putting to one side now the misrepresentations. What about the proximate cause?

MR. BEEBE: Before our people come in it's very clear that if the regulations had been imposed, either, A, the company would have been healthier, or B, our people would have been notified there were restrictions imposed.

THE COURT: There were self imposed restrictions.

MR. BEEBE: They weren't notified of that.

THE COURT: Secondly, is there any proof in this record that the company would have been healthier --

well, there is no proof in this record that the stock exchange -- that anything they would have done would have made a difference.

MR. BEEBE: I think we are splitting hairs. If nothing they would have done would have made a difference, our people should have surely known that fact.

THE COURT: There is no proof the stock exchange had done this or that, and if they had done this, X, Y and Z would have followed. There is no testimony to that effect, is there?

MR. BEEBE: The testimony is to the contrary, that they didn't do this, therefore, A, B and C followed.

THE COURT: Isn't there a requirement that if they had done X, there would have been a different picture and would have affected your client in a particular way?

MR. BEEBE: I think the jury can come to the conclusion from the evidence that they should have done something positive or alerted our people that nothing positive was possible.

I would like to add to the list of omissions, sir. We had six yesterday. The seventh is the voluntary

restrictions which weren't told to our clients either.

THE COURT: Could the jury conclude from this record what the exchange ought to have done and what effect that would have had on your clients?

MR. BEEBE: I think all they can conclude, your Honor, based on this record is that the exchange didn't do anything to improve the situation when they should have. The jury can, from the rules and from the actions the exchange took elsewhere and from the recommendations of the exchange examiners, infer there were many steps the exchange could have taken to improve the situation, to impose the restrictions, and the exchange did not do so.

Also from 86 and other testimony they can infer that the reason --

THE COURT: But there is nothing to the effect that would have had.

MR. BEEBE: They can go into the reason the exchange suspended the rules had nothing to do with bona fide wearing the good regulatory hat at all. It had to do with Exhibit 86, the self interest hat.

THE COURT: We are agreed there is no testimony of what the exchange should have done.

MR. BEEBE: Yes, there is, sir. I beg your

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pardon, sir. Mr. Schuette testified they should have imposed restrictions.

THE COURT: Not what restrictions, nor is there any testimony as to what effect those restrictions would have had upon your client either in terms of responsibility or damages.

MR. BEEBE: I think the jury could infer that it would have improved the situation and can also infer that our clients -- it's clear our client was not informed.

THE COURT: All right. Let's get the jury in.

(Jury present)

THE COURT: Good morning, ladies and gentlemen. We have been busy with matters of law since 10 yesterday morning. We went until about quarter past 5 last night and we have been going for half an hour this morning.

In that connection I think it fair to say at this point that you do not see Mr. Loflin at the counsel table because as a matter of law I have determined that there are no issues to submit to you with regard to the responsibility of the American Stock Exchange. So they are no longer before you and you are not to give

any consideration to them in any way.

You are not to speculate on the whys and wherefores. You will put that completely out of your mind at this point.

All right, go ahead.

MR. STEIN: Mr. Stargatt, please.

B R U C E M. S T A R G A T T, called as a witness, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. STEIN:

Q Mr. Stargatt, would you give your residence address, please?

A I live at 4602 Bedford Boulevard in Wilmington, Delaware.

Q Could you briefly describe your professional background and current business affiliations?

A I am a lawyer.

I attended the University of Vermont Undergraduate School received a Bachelor of Arts degree there; went to Yale Law School; graduated there in 1954.

I went into the service for a couple of years. I practiced in Washington before I went into service; decided to settle in Wilmington, and I have been practicing law there ever since.

I am admitted to the bar of this court. I was from New York originally, and took the New York bar when I got out of law school.

I am admitted in all the courts in the State of Delaware; the District of Columbia, the United States Supreme Court. I am a Fellow of the American College of

charge of any operation was recommending it. Why was he recommending it? There was arbitrage problems. Those

Trial Lawyers.

Q Are you a member of any law firm?

A I am a partnerin a law firm named Young, Conaway, Stargatt & Taylor in Wilmington, Delaware.

Q Now Mr. Stargatt, are you at all acquainted with the affairs of the now defunct brokerage firm of McDonnell & Company?

A Indeed I am.

Q Could you describe how you happened to have obtained such familiarity?

A Yes.

On April 5, 1971, I was appointed by our Delaware Chancery Court, which is a state court similar or performing functions in some way similar to the functions Judge Owens performs here, to serve as receiver for McDonnell & Company.

It was an equity receivership. That is sort of a state court bankruptcy proceeding for a Delaware corporation which McDonnell was.

Continuously since April 5, 1971, I have served as receiver for McDonnell & Company.

MR. STEIN: Your Honor, at this time I wish to offer in evidence what has been pre-marked Receiver Exhibit C for identification, and it consists of a certified copy

of the order which the witness has just described in his testimony; and since it is certified I believe it can be offered.

MR. BEEBE: I would simply say that I stipulate that this man is the receiver. We don't need this exhibit to do that.

THE COURT: Does that satisfy you?

MR. STEIN: Just the same, the document does contain some embellishment.

THE COURT: It may be received.

(Receiver Exhibit C received in evidence.)

BY MR. STEIN:

Q Now in connection with this receivership insolvency proceeding, do you report to any supervisory authority?

A In a way. I am sort of an agent of the Delaware Chancery Court. It is not sort of an employer-employee situation, but I am a fiduciary, sort of a fancy word for a trustee, who serves subject to the court's supervision and orders, and in that sense I do report to the court.

Q Can you just describe briefly, as trustee, whose interest do you represent?

MR. BEEBE: Objection. Calls for a legal conclusion, and I don't know --

THE COURT: Sustained.

I assume he is a trustee in reorganization of the corporation.

MR. STEIN: No, your Honor, I think he could explain the interest that he represents, which are facts, not conclusions of law.

MR. BEEBE: I believe they are conclusions of law. That is a trustee for a certain trust or a certain receiver or a certain company, I think that speaks for itself.

MR. STEIN: Let him answer the question. Let's out who he is trustee for.

THE COURT: Well, all right, go ahead.

A My responsibility is to the creditors of McDonnell & Company. My job is and has been over the past four years or so to try to collect as much money as I can to assemble an estate for the purposes of paying off creditors and identifying who the legitimate creditors of McDonnell are and causing them to be paid. That is my only interest as receiver, to try to accumulate an estate and identify and ultimately, hopefully, pay the bona fide creditors of the corporation.

Q Are there any administrative duties that you are required to perform?

A Yes. Administratively -- I suppose you could say

administratively -- we have had the job of identifying claims and causing them to be paid.

Q And have you set out procedures to that end?

A We have.

Q And could you just describe briefly how these procedures are set up, whether it involves categories of any kinds of claims and how these things are dealt with?

MR. BEEBE: Your Honor, excuse me, I would object to this line of questioning.

May we approach the bench on this?

THE COURT: All right.

(At the side bar.)

MR. BEEBE: I don't know where Mr. Stein is going but he seems to be leading to the allowance and disallowance of the claims down there. No inference could be drawn from that, and I think the jury should be instructed that no inference can be drawn from the allowance or disallowance of claims in another court. The only reason our clients even mentioned the efforts that they made later on to collect this is to show that they took good faith steps to mitigate their damages. If this receiver fund had paid them, of course that would have mitigated our damages. If a special trust fund had paid them that would have mitigated our damages. There are a lot of ways that one

could have mitigated damages, but they did not succeed. This is a lot of self-serving statements.

THE COURT: What is he going to say?

MR. STEIN: There was an attempt by James McDonnell to mislead the jury into the belief that he had a claim that was allowed, and it just wasn't paid, and he was somehow singled out for adverse treatment. That is the inference that I think flows from Mr. McDonnell's testimony, and I think I have got a right to explain and have the jury made aware of the facts here and how a receivership operates and what a receiver gets in the way of books and records and how he deals with the claims of creditors, and there are categories of claims, and where he gets his information from. I am leading to a foundation. I think the jury should know that this a proceeding that is supervised; that the receiver is a fiduciary and he has no axe to grind, and that he is attempting to discharge the fiduciary capacity in dealing with the claims of McDonnell & Company.

MR. BEEBE: Can I answer that very succinctly, sir?

There are two aspects here that trouble me a good deal. One, this man is being set up as a paper, a straw opponent whom he then is going to knock down, a straw

opponent, that there are some incredible inferences were apparently being drawn which were never intended on our side at all. The only reason we introduced anything about a receiver is to show mitigation. He made a claim. It was not allowed.

The other thing that is to me very troublesome--

THE COURT: I am puzzled as to how that would show mitigation of damages when you didn't get anything.

MR. BEEBE: We attempted to mitigate. Then the argument can't be made, why didn't you go down to Delaware? Well, we did.

But the second part -- and this is why I want an offer of proof -- he equated himself to the limit. He said he was a judge just like yourself --

THE COURT: He didn't say that. He said the state court in Delaware had appointed him, and it was a state court that had functions much as this court has. That is what I understood him to say.

MR. BEEBE: I heard him setting himself up as a judge who passed judgment on whether the claims were valid or invalid.

So then when he goes on to testify and say "I allowed or disallowed something," this is highly prejudicial to the jury, because they are going to be thoroughly confused.

They will say this has been disallowed somewhere else.

MR. STEIN: Isn't that what cross-examination is for?

MR. BEEBE: I would say that is so prejudicial, sir, and it has nothing to do with the facts in this case--

THE COURT: I think you have a point there, Mr. Beebe.

Let me ask you, Mr. Stein, was the claim disallowed?

MR. STEIN: The claim was allowed that-- some of the claims have been allowed as subordinated lenders. These were made as general claims against the estate. In some cases portions of the claim were allowed as subordinated lenders. Other portions were allowed as stockholders. One of Mrs. McDonnell's claims for $903.50 is a public customer claim.

The record here as it presently exists on James McDonnell's testimony here, I think it is very easy for the jury to arrive at the inference that somehow Mr. McDonnell was singled out for shabby treatment, and I have the reference here, and I think this is very prejudicial to the receiver.

Mr. McDonnell was asked whether or not he filed a claim. The question was at page 277 of the

transcript.

"Q Yesterday at the beginning of your testimony we marked as Exhibit 15 a claim that you made to the receiver in Delaware of McDonnell & Company for the value of your 300 shares.

Did there come a time when youreceived anything out of that claim?

"A Any money?

"Q Yes, it says claim for $20,718. Did you receive all or any part of that?

"A No, sir, nothing."

Now, I tried to ask him on cross-examination about the treatment of his claim, and he professed ignorance, and at that point I believe your Honor suggested that we try to deal with this in some other fashion.

THE COURT: The problem I see, Mr. Beebe, is that you may have opened the door by asking these questions, because the mitigation question does not really come into this unless it is raised by somebody, and it didn't have to be raised.

MR. BEEBE: Maybe something he said can put the whole thing to rest. He said he reads an inference from that that our man is singled out. Why not just ask the witness, and I won't object to that question.

MR. STEIN: It gets worse, because on 288 of the transcript on the debenture claim Mr. Beebe asked his client:

"Q Now, the claim which we marked as 11 in evidence yesterday was a claim for $318,622.97 plus interest; is that right?

"A Yes, sir.

"Q And how much did the receiver, Bruce Stargatt, allow in Exhibit 19B when he allowed this claim?

"A The whole amount, sir.

"Q That is what?

"A $318,622.97.

"Q Did he pay it?

"A No, sir.

"Q Did he pay any of it?

"A No, sir."

MR. BEEBE: That is exactly what I said.

MR. STEIN: The inference from that is that the family, Mr. McDonnell's family, is singled out for shabby treatment.

MR. BEEBE: If he thinks that is the inference he can ask that question and put that inference to rest. I think it is a paper tiger he is setting up.

MR. BROOKS: I think the way the record now stands

has an adverse effect on my client as well because it stands as if that claim was said to be valid by somebody and now it has just not been paid. That is not the fact. There is an explanation that goes with it.

THE COURT: I fear I must overrule the objection.

(End of side bar discussion.)

THE COURT: Mr. Beebe, don't you think I should make an appropriate limiting instruction at this point?

MR. BEEBE: I was just thinking, sir, that would be very much appreciated.

THE COURT: Ladies and gentlemen, there is going to be adduced before you certain proof about McDonnell family claims that were made before the receiver in the Delaware receivership about which you have heard a little bit here.

This is being offered on a question of the good faith of the parties and to explain more fully a matter that was first raised by Mr. Beebe on direct examination of an earlier witness, to put the matter in a complete setting as to what happened to these claims.

I want to caution you that in no way is any decision by anybody, acting either as a receiver or under his direction or supervision, no such decision is in any way to have any binding effect upon you or any advisory

effect upon you in any decision that you are to make.

In other words, whether a receiver did or did not do something in a Delaware proceeding with regard to any of these claims has no bearing whatsoever on your fact finding task.

Your fact finding task is fresh from the beginning as you sit here, and it is to be made by you and the evidence on this record and it is not in any way to be influenced by anything anybody may have done in any other proceeding, and this evidence is not being admitted by way of guidance to you or suggestion to you or having any effect whatsoever on how you are to decide this case.

Mr. Beebe, is there anything further you would like me to add along that line?

MR. BEEBE: Not at this time.

THE COURT: Very good.

BY MR. STEIN:

Q I think, Mr. Stargatt, just before the objection you were asked a question as to how claims were dealt with, how they are categorized and how they are handled.

Would you answer that question.

A Yes.

Let me say, to start off with, that the claims procedure is pretty well completed now except for loose ends.

There were hundreds of claims by hundreds of people against the receivership -- against McDonnell, and therefore against me as receiver for McDonnell.

Subject to the court's direction after I got a handle on what was happening at McDonnell -- I knew nothing about it when I started off as the receiver, any more than anybody in the courtroom here knew about this before this accident -- from the books and records of McDonnell we were able to ascertain that moneys were owed or appeared to be owed to various people.

We had a dual task: First, to figure out who the receivership owed money to, and, secondly, to figure out where the money was owed to the receivership. That second task has generated a lot of cash for the receivership, I think the record will show.

In the claims procedure, trying to get people paid whom the receivership owed money to, we sent out claims forms to all of the people who the books and records of McDonnell showed McDonnell to be indebted to.

In addition we published notices of the Wall Street Journal nationwide with respect to the McDonnell receivership, and inviting people who had claims against McDonnell which possibly didn't show up on the books and records, to come in and prove their claims

Those procedures, speaking generally, resulted in large numbers of claims being filed.

As they came in they were categorized in various groups. The first group were priority claims; those are claims that under the law that the receivership operates under were to be given not top attention in terms of time but were to get the first share of whatever the receivership assets were.

In that category there was one very small claim that is of no real importance, a small wage claim, but there was one large claim by the United States Government for taxes, and by law they are entitled to get the cream off the top, and that claim was for about $717,000.

Now, that claim is in contest. The receivership does not believe that that much money is owed in terms of taxes, but until it is otherwise adjudicated that is a basic claim.

The second category of payments were the general creditors of McDonnell, the people who were either customers who had not been paid out by the time the liquidator was finished with the McDonnell situation, or people who had sold goods to McDonnell or rendered services to McDonnell, or brokers who McDonnell owed stock to at the time it went under, and those people were treated by me as a second

category after the priority creditors, because they are entitled to share in the assets after the priority claims are paid.

Then came the subordinate creditors, and they were people who as the books and records of McDonnell show had lent money to McDonnell and agreed to have those moneys subordinated to other claims, like the claims of general creditors. There were $6,000,000 or so in subordinate items.

Then finally were the stockholders of McDonnell, people who bought the stock in McDonnell, principally family members but a lot not family members who came at the end of the line. So that theoretically if there were a huge amount of money to be generated, one would first look at the priority claims and pay that off. Then pay off the general creditors and then pay off the subordinated lenders and then divide in accordance with their stock the money among the stockholders.

Of course, if there were funds to achieve that result McDonnell perhaps never would have gone into receivership; so that happy conclusion is not going to be reached in this receivership.

Q You just mentioned family members. Has T. Murray McDonnell been paid anything out of the estate?

A No.

Q How about Morgan McDonnell?

A No.

Q Are you familiar at all with the name Thomas McKay?

A I am.

Q To your knowledge has his estate been paid any money out of the receivership estate?

A It has not.

Q Now let's talk a minute about the handling of the claims in this particular case, Mr. Stargatt.

I place before you certain trial exhibits; if you would be good enough just to look at them, Plaintiffs' Exhibit 8, Plaintiffs' Exhibit 11, Plaintiffs' Exhibit 12 and 15. You may use them to refresh your recollection.

Are you familiar with any of the claims that are before you?

A I have seen all these papers that have been marked now as exhibits. They were filed with receivership.

Q Can you state how each of these claims have been handled by the receivership?

A Yes.

These claims have all been allowed by the receivership, but allowed in categories that the McDonnell

books and records, respecting your Honor's ruling, without respect to this case, show that they belong in --

Q Let's see if we can make that a little clearer for a second, Mr. Stargatt. The Delaware court has not ruled on any of these matters, has it?

A I have ruled on these matters. The Delaware court has not.

THE COURT: Well, in your capacity as a trustee you make certain determinations. Put it that way.

THE WITNESS: Yes. I was not intending to use the word "ruling" inartfully because I do have a duty statutorily of ruling, so it is not simply an informal determination.

THE COURT: No, I didn't mean any informality.

BY MR. STEIN:

Q Let me just start with Mrs. Murphy's claim.

A Her claim I note from Plaintiffs' Exhibit 8 is in the approximate amount of $376,000. That claim I believe was allowed in its entirety. I don't have the rulings; they are not attached to the claims, but as a subordinated lender.

Q Could you just refer now to the claim of Anna McDonnell? I believe that is Plaintiffs' Exhibit 12.

A Yes. Plaintiffs' Exhibit 12 shows a claim for

$933.50 and a claim for $1,400,000.

The claim for $933.50 was a claim like any other claim of a customer of McDonnell. Mrs. McDonnell, James McDonnell's widow, had a small account with McDonnell & Company at the time the receiver was appointed, like lots of other people did, and so far as that amount is concerned she was accorded general creditor status. Her claim was allowed, but the $933.50 part of her claim was put in the same category as all the other general creditors.

With respect to the $1,400,000, my recollection is that that was divided into two parts, and that a portion of that claim -- I could be in error about this -- that both parts were subordinated. I think part of it was allowed as a subordinated lender and part of it as a stockholder. I think it was so categorized.

I might say the only claim in the group you have given me that was accorded general creditor status was the customer account that Mrs. McDonnell had.

Q Could you now refer to the claim of the two trustees. I believe that is Exhibit 11 before you, Mr. Stargatt. How was that claim handled?

A This claim which amounts to 318,000 odd dollars I am sure was allowed as a subordinated claim.

Q And finally, if you look at Exhibit 15, the claim

of Mr. McDonnell in his individual capacity of $20,718.

A That claim was allowed as a stockholder claim.

Q Now, in arriving at these decisions did you have anything to guide you?

A I don't know what you mean.

Q Well, did you have any records or any information that was able to guide you in the determinations that you have just made?

MR. BEEBE: I object. I don't see the relevance of this.

THE COURT: I will overrule the objection and let's see what the answer is. If it is inappropriate we will strike it.

A I had, of course, the claims themselves, and I had the books and records of McDonnell, and I had more than that; I had at that time a pretty fair fix on the McDonnell situation.

Q In your testimony a moment or two ago you mentioned handling claims as general creditor claims or handling claims as subordinated lender status or handling the claims of stockholder status. What are the consequences of handling of claims in those groups or those categories?

MR. BEEBE: I object, your Honor. I don't see what this has to do with this case. I'm not sure I understand what the question is directed to.

THE COURT: Do you understand the question?

THE WITNESS: Yes, sir, I think I do.

THE COURT: Answer it.

A Well, as a practical matter the receivership has assets of about $1,700,000. That involves largely collections. We were ablt tofollow up on a lot of money that was owed to McDonnell.

The government has a claim for $700,000, $710,000. That claim has yet to be adjudicated. But it really looks as though the government's claim, even if it were allowed by the courts, would be paid.

There are general creditors'claims against McDonnell, whose claims have been allowed of about $1,300,000 or so. Not including the claims that are in controversy here as general creditors' claims.

There are other claims that are in litigation also. There are huge amounts of subordinated claims. I think about $14 million in subordinated claims, counting, for purposes of discussion anyway, the claims at bar as subordinated claims.

That's the best I can say. The prognosis

doesn't look good for subordinated claims to be paid. It does look good for general creditors to be paid something, depending upon how much we have in terms of general creditors. There is just so much of the pie and it's so big; how you chop it up is the question.

Q One last question, Mr. Stargatt. We are talking about general creditors. Can you describe generally what the group of general creditors consists of?

THE COURT: I thought he had.

A I think I did.

THE COURT: I will sustain it.

Q Maybe I missed it. I'm sorry.

I have no further questions.

THE COURT: Any cross-examination?

MR. BEEBE: Yes, your Honor.

CROSS-EXAMINATION

BY MR. BEEBE:

Q Sir, you mentioned Tom McKay in the answer to some questions about family members and his estate. Tom McKay is not a member of the McDonnell family, is he?

A I don't believe I mentioned Mr. McKay, sir. I think I was asked whether any money had b een paid to

the estate of Mr. McKay, and I said there had been no money paid to the estate. But to my knowledge Mr. McKay is not a family member, to answer your question.

Q Now, the claims that you allowed to the various claimants here also have not been paid; is that right?

A There have been no claims paid by the receivership estate. Nothing has gone out of the receivership estate, save for the settlement of one disputed lawsuit that was paid with the Court's permission, there have been no payments, not to your clients or to anybody else.

Q Is it fair to say that as long as our clients remain in the subordinated lender category it's unlikely that they will receive anything out of the receivership estate?

A I would say that it's highly likely that if your clients remain subordinated they will receive nothing. And I would say that even in the unlikely event that there is more than enough to pay general creditors, that really doesn't look like it's in the cards but it's possible, the amount they received as long as they remain subordinated would be very small.

The other side of that coin is that if your clients are made general creditors, the amount that the other general creditors will receive will be much less because your clients' claims by themselves exceed the total amount of all the other dozens and dozens of general creditor claims.

Q You are not here testifying as to whether or not our clients should be made general creditors, are you? Because you don't know the facts, do you, of what occurred before you came in in April 5, 1971 at McDonnell & Company?

MR. STEIN: I object to the form. Is it a statement or a question?

MR. BEEBE: It's a question.

THE COURT: I will sustain the objection as to the form.

Q Sir, do you know of any of the facts, from your own personal knowledge, that occurred at McDonnell & Company before April 5, 1971, yes or no?

A I have only the knowledge, Mr. Beebe, that you have available to you. I have knowledge --

Q Sir, I believe that calls for a yes or no answer.

MR. STEIN: I think the witness was trying

to answer the question the best he can.

MR. BEEBE: It calls for a yes or no answer.

THE COURT: Mr. Stargatt, can you answer that?

THE WITNESS: If the question personal knowledge means did I view any of the events prior to the time of my appointment, I did not.

THE COURT: Go ahead, Mr. Beebe.

Q Sir, you testified that you put into the subordinated lender category persons who, your words were, lent money to the company. Did you treat those who lent their customer accounts as subordinated accounts as customers? Do you understand the question?

A No.

Q Were those people who lent their customer accounts, the stocks that were in their customer's accounts, to the company treated as customers, that is general creditors, in your categories?

A No. Anybody who is --

Q The answer is no; is that correct?

A I hope I understand your question properly, Mr. Beebe, but I think a word of explanation might make it clear.

Q I believe your attorney can clear that up on

redirect if any is necessary.

THE COURT: No, let's have the question read back so we can get it, if there is a concern.

MR. BEEBE: I believe some self serving statements are being made and I am trying to avoid that. If there is some need for him to answer it differently --

MR. STEIN: I think that statement is improper.

THE COURT: The comments of counsel are inappropriate. Let's have the question read back.

(Question read)

A No. But I would like, if I may with your permission, to give a word of explanation. People who executed subordination agreements may have done so by the use of cash in rare situations, and if I said cash, and I'm sure I did if you noted down my words --

Q Money was the word, sir.

A Money, the valuables that were ordinarily the subject of the subordination agreement were ordinarily securities. These people had accounts with McDonnell and in order to pick up extra interest which the corporation would pay them, because it wasn't gratuitous, they would sometimes subordinate their accounts and it was securities, really, that I intended to be the focus

of my answer. I'm sorry if it wasn't.

Q That was all I was trying to clear up, sir.

A Thank you.

Q Are you familiar with the New York Stock Exchange's special trust fund?

A When you say familiar, I don't want to grapple with your personal knowledge question before, but I certainly know about it like I know what happened at McDonnell. I have never seen the trust, never seen a report of the trust fund, but I certainly have general awareness of its existence.

Q Did the trust fund ever make a claim against the receiver?

A Yes, it did.

Q Yes, sir.

And so in that respect you became familiar with the trust fund because they made a claim against your assets?

A I became familiar with the claim of the trust fund and I had familiarity with the trust fund quite apart from the claim.

Q What was the basis as presented to you for the trust fund's claim against the receiver's assets?

A The best I remember, and you are going to have

to rely on my recollection, although the reports that have been sent to your clients detail this substantially, so if I am in error you, I am sure, can quickly correct it.

The trust fund had advanced to McDonnell something in the area of $8 million, if my memory serves, during the liquidation to help get McDonnell wound down and public customers paid. And they demanded or requested the return of that money, and the treatment of that money as general creditors of McDonnell. That was their claim.

Q And what was the determination of the receiver when it put that claim in the package and put it in one of the categories?

A Well, that can't be answered in a sentence because it took some little while. To start off with, the claim was denied. The receivership asserted claims against the New York Stock Exchange. There were discussions between the receivership and the New York Stock Exchange. Those discussions gave rise to a written settlement agreement with the New York Stock Exchange which was presented to the chancellor for his approval and approved by the Court.

The bottom line was that the stock exchanges

claim --

THE COURT: Is this relevant here?

MR. BROOKS: It seems beyond the scope of the direct testimony certainly. It doesn't seem relevant either.

MR. BEEBE: I think it's relevant to the point that the trust fund, of which we have heard a good deal of testimony, the exchange's special trust fund, had a strong interest in the outcome of what happened at McDonnell & Company and actually played a very active role in what happened to McDonnell & Company's assets. It had a self interest, if you will.

MR. BROOKS: So what, your Honor? It doesn't shed any light on the issues of this lawsuit.

MR. BEEBE: I believe we had two days of argument showing a good deal about that.

THE COURT: I will overrule the objection.

MR. STEIN: I join in Mr. Brooks's objection. I believe it goes beyond the scope of the direct examination of this witness. I would object to that.

THE COURT: If the only objection is to the grounds of relevance, I will overrule it.

Q You were saying the bottom line, sir.

A The bottom line was that the Court finally approved allowance to the stock exchange's claim but in a subordinated category. They are like subordinated lenders. The stock exchange agreed to advance to the receivership $300,000-odd which was necessary to pay off the remaining public customers of McDonnell, who hadn't been paid off by the time McDonnell went under and they were identified by the receivership as a result of these advertisements, and so on.

The stock exchange paid the receivership some cash, maybe $30,000 or $40,000, and the stock exchange was put into a general creditor category with respect to the $300,000-odd which was used to pay customers becausethe customers were general creditors and all the stock exchange was doing was swapping positions with them.

Q You mentioned just now of the stock exchange's claim, one portion of that claim was put into a subordinated position. How did it rank vis-a-vis general creditors and subordinated lenders? Was it higher than the subordinated lenders?

A I don't remember. I will say that --

THE COURT: There is no question, Mr. Stargatt.

Q How many McDonnell & Company public customers were there when the company went into liquidation on or about March 13, 1970?

MR. BROOKS: Your Honor, I think that is not within Mr. Stargatt's competence since he took over a year later.

MR. BEEBE: He had access and studied the records and told us he studied them very thoroughly. He is perhaps the best man to answer it.

THE COURT: Do you know?

THE WITNESS: Well, it again depends on what you mean by public customers. There were a few hundred whose accounts were open in the sense that they were owed money by McDonnell or they owed money to McDonnell.

Now, I can't tell you during McDonnell's halcyon days of prosperity how many customers it had at that time but we all know it was many thousands.

Q I am talking after those halcyon days, sir, particularly when you received a claim from the special trust fund for the monies it had disbursed, how many customers was it claiming that it had made payments to?

A I don't remember.

MR. BEEBE: I have no further questions on cross-examination.

THE COURT: Mr. Brooks, do you have any questions?

MR. BROOKS: I have no question of the receiver.

THE COURT: Mr. Stein?

MR. STEIN: I have no further questions.

THE COURT: We will stand in recess.

(Witness excused)

(Recess)

(In open court; jury present)

MR. BROOKS: The first witness will be Mr. Thomas Ford. Mrs. Lichstein will do the examining.

MR. STEIN: The receiver rests its case, your Honor.

THE COURT: All right.

MR. BEEBE: Could we approach the bench for a minute?

THE COURT: Yes.

(At the side bar)

MR. BEEBE: Your Honor, the problem is that we were told that Mr. Olney was coming first. It's important because we have been trying to get Mr. Ford's

diaries for the particular period in time that were used at his examination. Apparently he has them back at the office. We can't find copies that may have been furnished to us, so we subpoenaed the diaries. The subpoena is returnable in 20 minutes. I don't think he can find them in the next 20 minutes. I think he ought to be examined after lunch so he has a chance to get the diaries.

THE COURT: Is Mr. Olney here?

MR. BROOKS: Let me speak to that, your Honor. These diaries were requested by Mr. Dubin during the deposition. They were furnished to both sides, copies of them were, by Mr. Ford. We have our copies. Mr. Beebe's subpoena was served five minutes ago when Mr. Ford walked into this courthouse. It was served as a subpoena duces tecum and was served without a witness fee. They have the documents. If they have lost their copies we will furnish them.

MR. BEEBE: As long as I have the copies before I have to cross, that's fine. If he goes on right now there is no time.

MR. BROOKS: He is a very busy man and he has accommodated us.

MR. BEEBE: Could Mr. Olney also be excused?

We have been excusing these other reasons.

MR. BROOKS: I do object on the general ground that the next witness should get some feel for the courtroom.

MR. BEEBE: I think we have had this as a standing rule in this case.

MR. BROOKS: Not your witnesses.

MR. BEEBE: We would be pleased to excuse our witnesses.

THE COURT: Let's put Mr. Olney in the back room.

(In open court)

T H O M A S . F O R D , called as a witness by the defendant New York Stock Exchange, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MRS. LICHSTEIN:

Q Are you appearing here today pursuant to subpoena of the New York Stock Exchange?

A Yes.

Q In accordance with your deposition in this action, which was taken by the plaintiffs sometime, I believe, in 1973, did you produce for plaintiffs all of

your diary entries dealing with McDonnell & Company and all documents in your possession dealing with McDonnell & Company?

A Yes, I did.

Q Mr. Ford, out in the hall just now did you receive a subpoena from plaintiffs to appear in this action?

A Yes, it was just handed to me.

MRS. LICHSTEIN: The subpoena handed to Mr. Ford by plaintiffs calls for two categories of --

THE COURT: I want to hear your direct examination. Let's see where that subpoena becomes relevant.

Q Mr. Ford, what is your occupation?

A I'm a lawyer.

Q Where are you a lawyer?

A In New York City.

Q Do you work with a law firm?

A Yes, I do.

Q What is the name of the law firm?

A Shearman & Sterling.

Q And where does Shearman & Sterling have its offices?

A It has an office at 53 Wall Street, 399 Park

Avenue, one in Paris, one in London, one in Algiers.

Q How many attorneys work with Shearman & Sterling, Mr. Ford?

A 230, I believe.

Q Are you a member of the firm of Shearman & Sterling?

A Yes, I am.

Q For how long have you been an attorney?

A Since 1947.

Q And have you been with Shearman & Sterling all of that time?

A Yes, I have.

Q Where did you go to law school?

A I went to Harvard.

Q Do you have any particular background in law? Do you specialize in any area of law?

A Yes. I primarily am a tax lawyer.

Q Are you in charge of any particular departments at Shearman & Sterling?

A I'm in charge of the individual clients department.

Q Could you explain what the individual clients department is, please?

A Well, we represent -- we handle matters for

clients that are not publicly owned corporations, such as individuals, foundations, closely held corporations.

Q What types of legal matters would you handle for individuals or foundations?

A Pretty much everything, starting with the tax laws. Of course, the charitable foundations laws aer mainly tax; corporate, wills, trust, estates; general type of practice.

Q In accordance with your practice do you have many opportunities for personal meetings and conversations with your clients with regard to their legal problems?

A Yes.

Q Mr. Ford, did Shearman & Sterling ever represent McDonnell & Company?

A Yes.

Q For what period of time?

A I really don't know but for a long time. We incorporated McDonnell & Company when they started. We represented them before that. We represented them up until the time they, I guess, were put in receivership.

Q Did you personally have any function with regard to the McDonnell & Company account at Shearman & Sterling?

A Yes, I handled the account.

Q And what would the nature of your duties be in handling the McDonnell & Company account?

A Mainly it was to handle any problems that might come up. Because I was a tax specialist, things that involved the securities business were delegated out to the people in the corporate department. I didn't personally handle the securities end of the business.

Q So it would be fair to say there were other lawyers in addition to yours at Shearman & Sterling who were working with McDonnell & Company on a business basis?

A A large portion of the firm from time to time have worked on McDonnell's problems.

Q During the 1960's dud you and Shearman & Sterling represent any members of hte McDonnell family personally?

A Yes. We represented Mrs. McDonnell, Mrs. James McDonnell.. I would think that was progably the only other one member of the family.

Q Did you personally do any legal work for Mrs. James McDonnell?

A Yes. I prepared a will for her.

MR. BEEBE: Could we make it clear that Mrs. James McDonnell is who we have been calling

Mrs. Anna McDonnell.

THE COURT: Yes.

MRS. LICHSTEIN: Who is the plaintiff in this action.

Q So you prepared a will for Mrs. McDonnell?

A I think I prepared several wills over the years.

MR. BEEBE: I believe we are getting into privileged areas and unless there is a waiver by the client, which we deny, that testimony by a lawyer against his former client is privileged.

THE COURT: As I recall, the privilege goes to a communication and we haven't gotten into any communications.

MR. BEEBE: We are trespassing close. I will stay alert.

THE COURT: When you think that line is crossed you let me know.

MR. BEEBE: Yes, sir.

THE COURT: Mr. Ford, the same applies to you. You were the attorney representing the client. If you feel that there is a privilege at some point in connection with your representation, you speak up.

Q Do you recall having done any legal work for

Mrs. McDonnell in addition to writing a will for her?

A I really don't recall.

Q Mr. Ford, I believe that you testified in your deposition something to the effect that you had worked with Mrs. McDonnell on trusts, wills and problems of a personal nature. Would that refresh your recollection at all as to the types of legal dealings you might have had with Mrs. McDonnell?

A I believe, though again I don't know where the privilege provision applies here, there may have been, and I think there probably were, trusts along with the wills.

Q During the period of time when you were doing work with Mrs. McDonnell, did you have opportunities to speak with her?

A Oh, yes.

Q About how frequently would you speak with Mrs. McDonnell during the 1960's?

A I really can't say. But I would see her, I would think, a minimum of a half dozen times probably in a year.

Q A minimum of half a dozen times a year. In your discussions with Mrs. McDonnell did you ever meet with her socially?

A No.

Q Did there come a time during the 1960's where you had a meeting with Mrs. McDonnell with regard to subordination of her account at McDonnell & Company?

A Yes.

Q Do you recall when that meeting occurred?

A No, I don't.

Q James McDonnell has testified in this action that he believes that he attended a meeting with you and with Mrs. McDonnell in about 1962. Would that at least be an appropriate time reference for you?

A It's very difficult for me to remember back 13 years. My diary notes, which I have furnished you, ought to help on that, I would think.

Q I believe that the diary notes don't go all the way back to 1962. But anyway, do you recall where this meeting took place?

A Mrs. McDonnell's apartment.

Q To the best of your recollection who was present at this meeting?

A James McDonnell, Bob Aaronson, who was the accountant, and Murray McDonnell.

Q For whom was Bob Aaronson the accountant?

A I think he was the accountant for the company

as well as the members of the family.

Q What was the purpose of this meeting at Mr. McDonnell's apartment, Mr. Ford?

A Well, my recollection is that Mrs. McDonnell was planning to subordinate some securities with McDonnell & Company, and we went up there to explain to her exactly what this meant and what the risks were involved in doing such a thing.

Q Did you participate in this discussion with Mrs. McDonnell?

A Yes, I did.

Q Do you recall explaining to Mrs. McDonnell what the risks were attendant to subordinating an account at McDonnell & Company?

MR. BEEBE: Object to the form. I believe it's leading. I believe a lot of the questioning is leading. Why don't we just ask the witness what he recalls telling and what he recalls being told.

THE COURT: Let me hear that question back.

(Question read)

THE COURT: I will overrule the objection. You may answer, sir.

A I don't remember anything specific that anyone said but I remember the meeting lasted quite a

while and there was a continual discussion by all parties about --

Q About subordination?

A Yes, what it meant.

Q During this meeting did you form an opinion as to whether Mrs. McDonnell understood the discussion that was occurring?

A Yes.

Q Can you tell us on what you base your opinion that Mrs. --

MR. BEEBE: Objection. I don't believe the opinion of counsel for Mrs. McDonnell as to what he felt someone else felt at some meeting is at all relative, probative and in fact would be --

THE COURT: This is '62?

MRS. LICHSTEIN: Yes.

A May I have the question?

(Question read)

MRS. LICHSTEIN: I will scratch that question and start off again.

Q On what facts did you base an opinion as to Mrs. McDonnell's understanding of the discussion that had occurred?

A Well, Mrs. McDonnell is a very intelligent

woman. It was explained to her very thoroughly as to what she was doing and what the risks were.

Q And it's your opinion that Mrs. McDonnell had an understanding of the nature of subordination and what the risks were?

THE COURT: I'll sustain the objection to that.

Q Did Mrs. McDonnell ask any questions at this meeting?

A I don't recall.

Q Mr. Ford, do you remember having any communications or conversations with McDonnell & Company about the New York Stock Exchange rule 325 capital requirement?

A Yes, I remember having conversations.

Q Excuse me?

A Yes, I remember having conversations from time to time.

Q Do you remember when these conversations took place?

A There is no way I can pinpoint any dates.

Q Mr. Ford, in your deposition, in which you went through teh diary entries that you had regarding McDonnell & Company, there was a diary entry for

January 29, 1969, re a conference at McDonnell & Co. about 325 requirements.

Do you have any specific recollection of that meeting at McDonnell & Company?

A No, I don't.

Q Mr. Ford, your diary entry reflected that this meeting took place for three hours. Can you explain to the jury how you account for your time?

A Well, as a lawyer we every day put in time slips so that we charge the number of hours that we work to a particular client. We may work on four different matters a day. At the end of the day you write out a slip that says McDonnell & Company, three hours, X two hours, somebody else 15 minutes. That goes up to the accounting department and that's how we keep our time and hour costs and use it as a billing procedure. Basically it's used for billing.

Q Do you have any recollection as to this three-hour meeting that you had at McDonnell re the 325 capital requirement, whether this discussion was going on as to how McDonnell could raise additional capital for 325 purposes?

A I have no idea.

MR. BEEBE: Objection.

You don't recall?

THE WITNESS: I don't recall.

Q Mr. Ford, do you recall attending a meeting at the Carlton House in and around July of 1974?

A I remember attending a meeting at the Carlton House. Again I don't know when.

Q Do you recallwho was at that meeting?

A Well, I can try.

Q Okay.

A Paul McDonald, Murray McDonnell, Jim, Dean Johnson, Mrs. Johnson, Mrs. Sean McDonnell. I don't remember -- there was a large table and how many were there I don't really know.

Q Do you recall if Mrs. Anna McDonnell was present?

A I believe she was.

Q Can you tell us as best you can what transpired at that meeting?

A My recollection is that Paul McDonnell -- McDonald explained to the family, and this was a family group, the serious condition of McDonnell & Company at that particular time. It was my recollection that the meeting was called so that everybody in the family would be advised exactly how serious the

situation was.

Q Do you recall how long the meeting went on for?

A I would have to guess. Maybe two or three hours.

Q Did members of the family ask questions of Paul McDonald about the conditions of McDonnell & Company at that meeting?

A I don't recall.

Q During 1969 did you ever have any meetings or communications with Margaret Mary McDonnell Murphy?

A Just once where wewent over to her house, one Sunday morning.

Q Who is we, Mr. Ford?

A Murray McDonnell.

Q And you just said you went over to her house one Sunday morning. What was the purpose of your going over to her house one Sunday morning?

A My best recollection is that at this stage of the problems at McDonnell & Company they had to raise more capital and they had to get rid of what they called the haircut on the securities. There are two ways -- the normal way of doing that would be for McDonnell & Company to sell the securities, which would

have brought down a large capital gain on the various people who had subordinated their accounts.

From a tax standpoint we had worked out an arrangement whereby the subordinated lenders would take an installment note back. They would in effect sell the securities to the corporation and take back an installment note and this would not bring down the capital gain.

McDonnell & Company could then sell the securities without paying any capital gains and have the money to meet the requiremens of 325. It was mainly a tax arrangement to save the members of the family, the subordinated lenders, capital gains.

Q And when you went to Mrs. Murphy's house did you explain to her the tax consequences of converting a subordinated account into an installment note?

A To the best of my recollection this was the purpose of the meeting and what we explained.

Q Was Mr. Murphy present at this meeting?

MR. BEEBE: I would like a brief side bar conference about a question that's come up, if this is not going to be much longer.

MRS. LICHSTEIN: We will be about two minutes at the most.

MR. BEEBE: Then we will wait.

Q Was Mr. Murphy present at this meeting?

A Yes, he was.

Q Did Mr. Murphy actively participate in the meeting?

A I don't believe so.

Q Did Mrs. [illegible] ask any questions?

A Again I don't recall but it seemed normal that she would.

Q Did Mrs. Murphy agree to the installment note that was presented to her at this meeting?

A My recollection is that she didn't say anything and we left the papers with her, and it was several weeks later before they came back.

Q But they were subsequently signed by Mrs. Murphy?

A Yes.

MRS. LICHSTEIN: I have no further questions, your Honor.

MR. BEEBE: May we have a side bar conference?

THE COURT: I believewe will go into the robing room.

(In the robing room.)

MR. BEEBE: It will be very brief.

Paul McDonald, who apparently is another witness, strolled into the courtroom. I in turn would ask that we have the same rule apply to him, and I was told to make

an application, so here I am.

MR. BROOKS: I don't think Mr. McDonald's testimony overlaps at all Mr. Ford's testimony. I didn't see any need to break into the interrogation and to ask Mr. McDonald to step outside for a minute or two.

MR. BEEBE: That is why I didn't press it, because for another minute or two it didn't make much difference, but on cross I would like to have the same rule apply, and I am sorry I have to come in and ask for it. Paul McDonald definitely does overlap in that period. In fact, he attended one of those meetings that Mr. Ford is testifying to.

THE COURT: All right, we will put him with the other witnesses.

(End of robing room discussion.)

(In the courtroom.)

CROSS EXAMINATION

BY MR. BEEBE:

Q Excuse me, sir, I have just been handed a list of your diary entries or what are said to be the diary entries for 1968 and 1969.

Let's start with the question of whom you represented at which points. You mentioned that you represented Mrs. Anna McDonnell in her personal matters. For

what period of time were you representing Mrs. Anna McDonnell as an attorney?

A I don't remember. It is hard to say, but for a long period of time.

Q Would it be fair to say that it was several years, anyhow, before 1962?

A Yes.

Q And have you continued to represent her since then?

A I don't think I represented her since.

Q When did you cease representing her, do you know?

A She hasn't called me for several years. I don't know.

Q In that meeting in 1962 that you testified about this morning -- by the way, did you also represent T. Murray McDonnell?

A Yes.

Q You also represented McDonnell & Company?

A Yes.

Q Always as an attorney?

A Yes.

Q Now, the meeting in 1962, at that time were you at various times representing those three different people; that is, the company, T. Murray and Mrs. Anna

McDonnell, so that there was an overlap at that time, is that right?

A Yes.

Q Whom did you represent at the meeting?

A If I represented anybody I would assume that I represented the company.

Q Did you inform Mrs. McDonnell at the meeting that you were not representing her interests there?

A No, I don't believe I did. Mrs. McDonnell was fully familiar with my relationship with McDonnell & Company and Mr. McDonnell.

Q Did you inform Mrs. McDonnell at that meeting or before that meeting at any time around then that she should obtain other legal counsel in connection with the subordination question then pending?

A No, I don't believe I did.

Q Did she obtain other legal counsel as to that question?

A I don't know.

Q Was the firm of McDonnell & Company at that time, 1962, when she first subordinated her funds, was it in financial difficulties?

A I don't recall.

Q You gave a deposition under oath in this matter

on October 3, 1973; do you recall that, sir?

A Yes.

Q And you signed and returned a sworn copy of that, do you recall that?

A Yes.

Q On page 20 of that deposition you were asked:

"Was the firm of McDonnell & Company in approximately 1962 - which is the time, I believe, that Mrs. Anna McDonnell subordinated her account - was the firm of McDonnell in financial difficulties at that time?"

And your answer was: "No."

And then the question was asked: "That you know of?"

And the answer was: "Not that I know of. They were expanding very fast."

And there is more to that answer.

MR. BROOKS: I would ask that the more to that answer be read.

MR. DUBIN: I would be pleased to read the more.

"And I believe"-- this is the rest of the answer at that point -- "not being an expert in the capital requirements of the stock exchange, but as they opened new offices it took more capital to do it and they were opening offices I think quite regularly in the '60s."

Was that your answer and your testimony in the deposition?

A Yes.

Q And was it accurate?

A I believe so.

Q Now, coming to January, 1969, was the firm of McDonnell in financial difficulty?

A January, 1969?

Q Yes.

A I believe that was the period when they were having trouble with their capital requirements with the stock exchange.

Q I show you this list of diary entries which you sent after your deposition, which we should have marked for identification --

(Marked Plaintiffs' Exhibit 94 for identification.)

MR. BEEBE: I don't think we need the covering letter.

Q -- and ask you how that list came to be prepared.

A Your office requested it.

Q What did you do in response to the request?

A I had my secretaries go to my diaries and type up this list and sent it over to you.

Q What did you instruct her to do?

A To copy verbatim what was in the book.

Q Concerning any particular subject, sir?

A To my recollection, whatever you asked for I gave you.

Q Anything on McDonnell?

A Right.

Q There is a reference in here on April 17, 1968: "Conference, Lunney."

Who is Lunney?

A Mr. Lunney is an attorney who worked for Shearman & Sterling.

Q At that time?

A At that time. Mr. Lunney has since left. Whether he left before or after that, I don't know.

Q What was that conference about?

A I have no recollection.

Q Same entry: "Telephone conversation Krouse and letter re bill."

Who was Krouse?

A Krouse is one of our security lawyers.

Q And what was the telephone conversation about?

A I have no recollection.

Q On April 29, 1968: "Luncheon conference T.M. McDonnell."

What was the occasion or the substance of that meeting?

A I have no recollection.

Q Sir, at that time did you make memoranda to the files concerning significant legal advice you gave or--

A I practically never make a memorandum to the files.

MRS. LICHSTEIN: Excuse me, your Honor, I think the scope of the cross-examination is going far beyond the scope of the direct examination and is improper.

THE COURT: I will allow it for the present.

BY MR. BEEBE:

Q Now, you say you practically never made memoranda for the file. Did you give written advice to clients and submit letters to them from time to time?

A I wrote letters, yes.

Q Including McDonnell & Company?

A Yes.

Q In this era, 1968, 1969?

A Yes.

Q Did they ever ask you for advice with regard to their operating problems?

A What kind of operating problems?

Q Whatever operating problems they may have had.

A I don't know what you mean by operating problems.

Q I am asking you, at that period of time were you ever approached by McDonnell & Company with regard to problems they had in connection with their operating conditions and complying with the New York Stock Exchange rules?

A Yes.

Q They did?

A Yes.

Q And when did they approach you on this in 1968? Can you give us a time frame?

A I have no idea. I was in constant communication with McDonnell & Company every day for ten years, and it would be like asking your wife what you discussed on last 4th of July with her.

Q Sir, maybe it would help if we could look at the files and records that you maintained of written advice?

A They have all been destroyed.

Q You say they have all been destroyed?

A Yes.

Q When were they destroyed?

A Again, I think I told you in my deposition it was before this case started.

Q This case started in 1971. Are you saying they were destroyed before 1971?

A I would have to go back and search my records. When we ceased being counsel for McDonnell & Company I sent all the files of McDonnell & Company to the warehouse with instructions to return them in three years for destruction.

Q That would be 1973, would it not?

A Oh, no, it was way before 1970, I think -- or maybe it was one year. Maybe it was one year. Anyhow, the file room sent the files back to me, and we hadn't heard anything from anybody for years, and we destroyed them all, which is our normal way of handling our files in our office.

Q Sir, may I refer to pages 5 and 6 of your deposition where you gave a similar explanation, except it was in terms of three years.

I will show you a copy and see if that refreshes your recollection.

A I thought it was two years too.

Q So it was 1973 when you destroyed these files?

A No, I don't think so.

Q Page 6:

"In 1973" -- this is part of your answer "the

file room called me and told me" --

A All right, if that's what it says then I will have to go back and refresh my recollection. Maybe it was January, 1973, but this was before I had heard anything about this case.

MR. BEEBE: Will you mark this deposition for identification.

THE COURT: You don't have to mark that. It is being marked.

Q It was 1973?

A That's quite correct. Normally it was three years.

MRS. LICHSTEIN: I object, your Honor. I don't think this line of questioning is relevant at all.

THE COURT: Yes, I tend to agree, and it is beyond the scope of the direct, and I was permitting it on the theory we wouldn't have an awful lot of it.

If you are going to make him your own witness at this point it seems to me it either should have been done as part of your case or part of any rebuttal case you might choose to offer.

MR. BEEBE: Well, sir, I was really going after the diaries they had mentioned in their examination, and trying to elicit from this witness what precisely happened

during that era.

Now we have no files to do it with, and we have to do it with the witness as it stands.

THE COURT: You have diary entries.

MR. BEEBE: I have entries.

THE COURT: Don't you have diary pages? Wasn't I told that earlier?

MR. BEEBE: Yes, and I subpoenaed the diaries themselves, but they have not --

THE COURT: Maybe copies will be made available to you.

MRS. LICHSTEIN: They have been made available since 1973, your Honor.

MR. BEEBE: Not the pages. This is a summation.

THE WITNESS: That is not a summation. That is verbatim, taken right out of my diary.

MR. BEEBE: Then we will examine based on this.

THE COURT: Go ahead.

Q You have a mention here of May 23, 1968 "Telephone conversation Volk and Monig."

Who is Volk and Monig?

A Two lawyers at our office, both security lawyers.

Q This mentions a half hour conversation. What was the half hour conversation about McDonnell & Company?

A I have no recollection.

MRS. LICHSTEIN: I object again, your Honor, on the grounds that this is going far beyond what we covered in the direct examination and it is not relevant at all.

MR. BEEBE: We have this witness here --

THE COURT: What are you seeking to elicit at this point?

MR. BEEBE: The facts as to what occurred in 1968 with regard to this person who has apparently waived the privilege as to his dealings with McDonnell & Company, what he did in regard to the company at that time--

THE COURT: The company. As I understand the direct examination, it had to do with Mrs. Anna McDonnell, not with the company.

So I will sustain the objection on the ground that it is beyond the scope of the direct.

MR. BEEBE: Well, perhaps we will get into this in the rebuttal case, then. I would just ask the witness to remain available on those areas and I will pursue the cross on the areas that have been explored so far.

BY MR. BEEBE:

Q Did you or anyone in your law firm bring Mrs. Anna McDonnell up to date as to the conditions at McDonnell & Company in 1968 and 1969?

A I don't recall.

Q You have testified that there were difficulties at McDonnell & Company in 1968 and 1969, is that right?

MRS. LICHSTEIN: I object, your Honor.

THE COURT: Ask the question differently.

MR. BEEBE: I will just ask a straight question:

Q Were there difficulties at McDonnell & Company in 1968 and 1969? And please be specific as to what they were.

A I don't know about 1968 because I was living abroad most of 1968 running our Brussels office.

In 1969 my recollection is they were in difficulties, and this was when the capital requirement problems came in.

Q Do you recall whether you or anyone else at your firm took any steps to alert Mrs. McDonnell about those facts?

A I don't believe so.

Q Now, sir, you were asked about a diary entry of January 29, 1969, which, according to this list, reads as follows:

"Conference at McDonnell & Company re 325 capital requirements," and it indicates three hours.

Was that held at McDonnell & Company?

A What does it say there?

Q Conference at McDonnell.

A I would say that is correct.

Q Who was present?

A I have no recollection of the meeting of any sort.

Q You have no recollection whatsoever of that meeting?

A No.

Q There is a mention here just before this of a man named Hovdesven.

A He is a lawyer in the office.

Q What was your conversation on January 21, 1969, for a quarter of an hour? Do you recall what subject it would be on?

A He was a securities man.

Q It would relate to McDonnell & Company, because it is on this list?

A Yes.

Q On January 17th: "General lunch with O'Brien et al. Who was O'Brien?

A Larry O'Brien was working at McDonnell & Company. I think he was president.

Q And who are the et al?

A I don't remember.

Q Do you recall anything about that conversation

on January 17, 1969?

A No.

Q Except that it related to McDonnell & Company?

A Right.

Q Moving on to the meeting at the Carlton House that you testified about:

"Whom were you representing at that Carlton House meeting in your capacity as an attorney?

A I imagine I was representing the company.

Q Did you inform Mrs. Anna McDonnell that you were not representing her at that meeting?

A No, I did not.

Q You did not mention among the people there Mrs. Margaret Mary Murphy.

Have you any idea she was not invited to attend?

A I did not know she was not invited to attend.

Q You said that serious conditions of the company were explained.

Who explained them?

A I believe that Paul McDonald did.

Q Exactly what did he say?

A I have no recollection.

Q You mentioned serious conditions. Do you have some recollection of any --

A I can guess what was said but I don't have any recollection.

Q What made you say he discussed serious conditions

A Because I remember that was the purpose of the meeting, was to bring them up to date, and I believe that Mr. McDonald was the one that gave the speech.

Q Did you say anything at that meeting?

A I would doubt very much that I did.

Q What was your purpose in attending?

A Because I was asked to.

Q Now let's move to the meeting you had with Mrs. Murphy on a Sunday morning at her house.

Was that the only time you visited her house in 1969?

A I believe that is the first time I ever saw Mrs. Murphy and the only time I have ever been to her house.

Q Was that on or about October 12, 1969?

A It was a Sunday morning.

Q If I said October 12, 1969, would that sound about right?

A It must be in the diary notes.

Q You are absolutely right. Her name is indicated as "Conference Marjorie Murphy," but I believe that is Mrs. Margaret Murphy.

A That is the only Murphy it would be.

Q And it is indicated as October 12th?

A Yes.

Q So that refreshes your recollection that that was the date, is that right?

A Well, I just assumed that what was in my diary was accurate.

Q In discussing the reorganization arrangement that you said you had worked out, did you offer Mrs. McDonnell at that meeting any choice as to whether or not she could--

MRS. LICHSTEIN: I object, your Honor. First, Mr. Beebe'squestion talks about a meeting with Mrs. McDonnell, and I think he means Murphy--

MR. BEEBE: Mrs. Murphy.

THE COURT: Why don't you put the question again.

Q Let me put it again:

At the meeting with Mrs. Murphy did you offer her or state to her that she had any choice as to entering into that arrangement?

A I don't recall. What I do recall is that I was there to explain to her what happened if they sold off the securities, she would realize a capital gain, and what would happen if she signed an installment note, and the difference in the tax consequences.

Q You went with someone to that meeting, did you not

A Murray McDonnell.

Q And he stood outside the room or elsewhere when you were talking to her, is that right?

A My recollection is that he went upstairs and made a phone call I believe to Mr. James McDonnell.

Q Did Mrs. Murphy ask you if she had any choice as to entering into the transaction?

A I don't recall.

MR. BEEBE: No further questions on cross-examination of this witness.

THE COURT: Redirect?

MR. STEIN: Your Honor, I just have one or two questions on cross-examination.

THE COURT: All right.

CROSS-EXAMINATION

BY MR. STEIN:

Q Mr. Ford, my name is Steven Stein; I am a member of the Proskauer firm. I represent the receiver in this case. I just have one or two questions I would like to put to you about the meeting with Anna M. McDonnell which I believe you said was in the early '60s.

Can we just go over that for a minute.

Who, if you can recall, was present at that meeting

A Mrs. James McDonnell, James McDonnell, Bob Aaronson, Murray McDonnell and myself.

Q Can you recall what occasioned that meeting?

A Yes. They were going to go up and talk to Mrs. McDonnell about subordinating some securities of the firm.

Q Can you recall whether or not the meeting was held prior or after Mrs. McDonnell's subordination of her account?

A I don't know. I don't know.

Q Perhaps I can help you:

Do you recall giving testimony at a deposition in this case on October 3, 1973?

A Yes.

Q Do you recall being asked this question, I believe, by Mr. Brooks --

MR. BEEBE: Could we have a page?

MR. STEIN: Page 18.

Q "Q Do you recall whether this meeting was held prior to or subsequent to Mrs. McDonnell's subordinating her account?

"A My recollection is it was before she subordinated it."

Does that refresh your recollection?

A I really have no recollection. I don't see why

you would do it after she had made the subordination. I would assume that as before, but I don't really know when she put the securities in.

Q Can you recall what was said to Mr. McDonnell at this meeting?

A I can't recall anything specific that was said.

Q Well --

A Generally they explained what subordinating securities meant.

Q Do you recall whether or not the risks and the dangers were explained to her?

A I have no recollection, but that was the purpose of the meeting.

Q Perhaps I can help you by going back to this deposition, page 19, where Mr. Brooks asked you:

"Q Do you recall, in substance, what you stated to her" -- meaning Mrs. McDonnell?

"A No.

"Q As to subordinating her account?"

MR. BEEBE: Excuse me, before you read the last part of that answer I would object to the last part of the answer, again. I don't want it read on the record until it is ruled on. It is lines 9 and 10.

MR. BROOKS: I think we should correct the record

to show that the questioner was Mr. Dubin and not Mr. Brooks.

MR. DUBIN: But the last part I would object to, your Honor, and ask for a ruling on my objection, since it is an obvious conclusion.

THE COURT: Mr. Dubin was the questioner?

MR. BROOKS: Yes, he was.

THE COURT: There is no motion to strike that answer --

MR. BROOKS: There was no objection by any part.

MR. BEEBE: But all objections were preserved. That was the specific stipulation.

THE COURT: As to form.

MR. BEEBE: All objections except as to form were preserved. The usual procedure is not to clutter a deposition with objections but to wait until the trial.

THE COURT: Mr. Dubin asked what he based his opinion on that he understood the risks, and he got the answer he got.

MR. BEEBE: That is not the question I am objecting to. The question I am objecting to is the last self-serving statement, and that I believe--

THE COURT: That's what he based his opinion on. Is it lines 15 and 16 that you are referring to?

MR. BEEBE: No, lines 9 and 10, sir. I'm sorry, I didn't make that clear enough.

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United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 76-7278

B

MARGARET MARY McDONNELL MURPHY,
Plaintiff-Appellant,

against

McDONNELL & CO., INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,
Defendants.

JAMES F. McDONNELL, JR., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and CHARLES E. McDONNELL, as Executor of the Estate of Anna M. McDonnell,
Plaintiff-Appellants,

against

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary, and McDONNELL & CO., INC.,
Defendants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

JOINT APPENDIX (Vol. A-6)

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UNITED STATES COURT OF APPEALS
FILED
OCT 12 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

October 8, 1976.

PAGINATION AS IN ORIGINAL COPY

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MARGARET MARY MC DONNELL MURPHY, et al.

vs. 71 Civ 461
71 Civ 1940

MC DONNELL & CO., INC., et al.

May 14, 1975
10:00 a.m.

Trial resumed.

- - -

(In open court; jury present)

P A U L M C D O N A L D resumed.

CROSS-EXAMINATION

BY MR. BEEBE:

Q Mr. McDonald, yesterday you testified about some events that occurred late in 1968 when you were invited to look at the company, McDonnell & Company, and asked whether you could arrange or yourself contribute funds to its capital.

What was the form in which you were asked to make that investment?

A It would have been in the form of a subordinated loan.

Q And did you examine the subordinated loan instrument that you were being asked to enter into?

A Yes, sir.

Q What conclusion did you reach?

A I concluded that it was not a relationship which I would enter.

Q And what was your reason for that?

A The subordinated loan agreement, in my judgment, surrenders substantially all rights of the lender to his money and subordinates it to a very high degree of risk.

I think that my comment at the time was that I might just as well walk over to the window and drop the money out.

Q Did you look at the financial and operating condition of McDonnell & Company at that time as well?

A Up to a point, yes, sir.

Q Had you observed at that point in the fourth quarter of 1968, that the business of the company, brokerage activity had slowed down?

A I did not at that time observe that fact. I saw it later in retrospect.

Q Sir, if I might remind you from your deposition, page 13, your answer was to the question:

"Q Can you tell me what information you received that led you to the conclusion it was not an opportunity which you felt where you should invest your money? "

You said:

"A They also gave me a financial statement which indicated that the brokerage activity of the business had slowed down in the fourth quarter of 1968 and, of course, this was expanded levels of expense."

Does that refresh your recollection that you were?

A Yes, they did give me such a statement. They couldn't have given me such a statement for the fourth quarter before the end of the fourth quarter.

Q So the statement they gave you during the fourth quarter indicated that business had already slowed down somewhat in the brokerage area?

A Well, I always have difficulty pinpointing the time six years ago when I learned a fact.

Q In the course of making your decision not to make the investment at that time, were you told that they were having problems with the requirements of the New York Stock Exchange?

A I was told that they were having capital problems. Now, again, whether I learned that it was a 325 problem then or whether I learned it later is very difficult for me to identify.

Q If I remind you the next page of your deposition which you gave in this case on October 9, 1973, almost a year and a half ago, your recollection might have been a little better. The answer to the question of whether you were informed prior to April of 1969 that they were in violation, your answer was:

"They told me they were having problems with the requirements of the stock exchange. Exactly which problems they depicted and whether or not they indicated that they were in violation I can't be certain. I feel very strongly they did not tell me they were in fact in violation of any requirements of the New York Stock Exchange, or plainly I wouldn't have even considered the investment.".

A I don't see that that conflicts with what I just said.

Q My question is, sir, why would you not have even considered the investment if they were in violation or if they told you they were in violation?

A Well, it would be a very poor judgment.

MR. BROOKS: It's a hypothetical question since that state of facts, according to the witness' testimony, was never presented to him.

MR. BEEBE: I believe the evidence indicates the state of facts did exist.

MR. BROOKS: Not to the knowledge of the witness.

THE COURT: I'm not so sure this is relevant to our inquiry.

You are then going to draw some parallel to somebody else where the facts may be different? You are getting an opinion from this man as a potential investor. How does that bear on any other potential investor or actual investor?

MR. BEEBE: For instance, your Honor, if the jury finds that the --

THE COURT: Let's not get into alternatives of that kind. Do you claim they can draw a conclusion from what this man might or might not have done in '68 as to what someone else in the McDonnell family might or might not have done in '69?

MR. BEEBE: This is 1969, the end of '68.

THE COURT: He is talking about '68, the fall of '68.

I am going to sustain the objection.

MR. BROOKS: It's important to note Mr. McDonald was investing other people's money, not his own.

THE COURT: I don't think the opinion of this gentleman is relevant or probative.

BY MR. BEEBE:

Q Were you informed at that time of the status of the books and records of McDonnell & Company for the year 1968?

A By "at that time" you mean the last quarter of 1968?

Q At the time you were making your decision, which I understand was the last quarter of 1968 up to February of 1969?

MR. BROOKS: Oh, your Honor, that testimony has never been given by the witness, up to February, 1969.

MR. BEEBE: It was made in his deposition.

THE COURT: Let's lay a foundation, then, for this.

Q How long did you consider or review the questions before you made your final decision not to go ahead with some investment?

A It was in February of 1969 that I came up from Florida and told them that I was not going to make the investment.

Q Now, having laid that foundation, were you informed prior to that time as to the status of the books and records of McDonnell & Company for the year 1968?

A Well, I don't mean to be evasive. Certainly I

was told how the business was going. I saw financial statements as recent as they had at that time, and I saw a rather detailed cash flow projection for the future of the business.

Now, I certainly didn't go into books and records, which I think is your term, myself fully in an accounting sense.

Q I didn't mean it in an accounting sense; I meant it as of the status of the records of the company, its own record keeping, if it had any record keeping problems at that point.

A Oh, record keeping problems? Yes, I was definitely told that there were record keeping problems.

Q And were you told that those record keeping problems came from the attempts to automate, put the company's records on a computer?

A That was the primary cause that was blamed, yes.

Q Were the record keeping problems and the capital problems given to you as some of the reasons for requesting you to arrange or help to raise some capital?

A Not really. The primary reason given to me was growth and expansion.

MR. BROOKS: Your Honor, I am going to object for the same reason we did before, that I don't think it

appropriate to try to draw a parallel of Mr. McDonald's experience as investment adviser and decisions about whether or not to put his client's money into this firm.

MR. BEEBE: That is not the sole purpose of bringing up his testimony, your Honor. The purpose is to bring out what was known to the company at the time and what the company informed the man who asked the right questions. These were the facts that the company had in its possession, and there could be, then, no question if we can show it --

THE COURT: Objection sustained.

Q Did there come a time when Margaret Murray Muphy came to your office with her husband and discussed with you her subordinated position at the company? I can pinpoint that, I believe, in September, 1969.

MR. BROOKS: I rose to object that it was not within the scope of the direct, but I am not sure about that now, so I will sit down.

A They could have, counsel. There were many visits by many people, and I am having difficulty recalling that specific visit with these people, but they certainly could have.

Q Well, Mrs. Murphy, do you recall her requesting quite vigorously the right to withdraw from the company, withdraw her subordinated account?

A I don't recall that, but that doesn't mean it didn't happen.

Q Do you recall the telephone conversation with her which one might characterize as extremely vigorous on her behalf making this request?

A I recall one or two telephone conversations with her in which she expressed some discontent with the state of affairs. Whether she specifically on some particular telephone call demanded anything in particular, I honestly don't recall.

Q Did you at the meeting at the Carlton House offer Mrs. Anna McDonnell the opportunity to withdraw her subordinated account?

A Oh, I would not think so, counsel. I don't believe we offered anybody any out at any time.

Q That would include Mrs. Murphy?

A I think that is correct.

Q Mrs. Murphy was at the Carlton House meeting, was she?

A I don't know. I was more or less asked that yesterday, and I went into that meeting without, I think, being introduced to the individuals. So they could have been there.

Q Would you know of any reason why she had not

been invited?

A No.

Q You mentioned a black Friday plan yesterday. Will you describe for the jury what black Friday plan is?

A Well, in many companies, at least in my company, that is just a handle that we use to describe a down side contingency plan.

Q If everything goes wrong --

A -- here is what we could do to liquidate the business.

Q You mention that the staff had prepared that. Was that plan in existence in writing somewhere?

A Pieces of it were in writing.

Q Was it in existence before you arrived on the scene?

A Pieces of it were.

May I answer that a little more fully to clarify it?

Q Please do.

A I really don't think that the plan was developed before I got there, because there wasn't any contemplation given to liquidating the company. There were two or three very vigorous schools of thought in the company as to which direction it should go, so they had put together alternative plans for closing down this part which we don't like, closing

down that part which you don't like.

Q Did they receive any direction from the New York Stock Exchange?

MR. BROOKS: If he is asking the witness what direction they received, and the witness was not on the scene, I will object.

THE COURT: Yes, sustained. Absence of foundation.

BY MR. BEEBE:

Q Do you know from what you learned after you came on the scene whether before that time McDonnell & Company had received any specific direction from the New York Stock Exchange?

A I really can't testify as to what was -- what transpired before I got there, no.

Q You testified yesterday -- moving now to a period in 1970 -- that the SEC moved to impose sanctions on the firm or individuals in the firm for prior practices.

Were you one of those individuals?

A Oh, no.

Q Was this before your tenure?

A Certainly.

Q What were the prior practices?

A Well, by and large they were brokerage practices performed by individuals in various branch offices years

before even --

Q Apart from the brokerage practices, what were they?

A Then there were some management problems particularly regarding the chief executive of McDonnell & Company.

Q Anything you can recall? Were there capital problems?

A Oh, well, this is within the compass of the management problems, to my recollection.

Q Record keeping problems?

A Yes.

Q How far back did they go?

A How far back did the problems go or the charges?

Q The charges.

A I don't know.

Q The problems.

A I would say it was years rather than weeks.

Q You mentioned a press release in August, 1968. Did the company ever issue a later press release or any other public announcement changing or retracting what had gone out in the first press release?

A No, I don't recall that they ever did. It was considered, but there never was a moment during the ensuing

months when we didn't think that we might have more or less that same $3,000,000 from some other source.

Q But it never came in?

A It never came in.

MR. BEEBE: No further cross.

MR. BROOKS: I have one or two questions on redirect.

REDIRECT EXAMINATION

BY MR. BROOKS:

Q Mr. McDonald, you said that when you analyzed the subordination agreement which was proposed that your clients might put some money into McDonnell in the late 1968 period, you determined from reading that agreement that was not the position that you would advise an investor to take, sir.

Now I show you Plaintiffs' Exhibit 3, which is Mrs. Murphy's subordination agreement, and ask you if that was the kind of agreement that was presented to you at the time in late 1968?

A This is a rather lengthy document.

Q I realize it is somewhat unfair to ask you to make an analysis of it while you are sitting here, but perhaps without doing that you can get at it another way.

Can you tell me what particular features in the subordination agreement that was presented to you you

found objectionable and why?

A Well, I think if I had time I would be able to identify language in here -- maybe this is it here in the subordination, section 2, which makes very clear that the investor in the event of any kind of trouble is absolutely the last person to get any money out of the firm, and I would think that normally a creditor position would be better than that.

Q In other words, a bank making a loan to a brokerage firm would stand ahead as a matter of priority to a subordinated lender?

A So I understand.

Q Would a subordinated lender, as you understood it, be in a worse position than a stockholder holding equity stock?

A Well now, just right now without analyzing this I couldn't answer that question, but certainly this agreement, as I recall reading it six or seven years ago, surrenders substantially all rights, and there are places you can put your money where you don't have to do that.

Q Can you tell me from the review that you have made of Exhibit 3 whether it was in general the same kind of subordination agreement that you considered in late 1968?

A I clearly remember some of this language, counsel.

(Pause)

A (Continuing) If this is different from the subordination agreement which I vie d at the time, I cannot presently identify the difference.

The substance of what I see here is the sort of thing that frightened me away, and I would read one sentence as an example if you would want me to.

Q Please do.

A "With respect to each account the owner hereby agrees to subordinate and hereby irrevocably does subordinate any and all claims which he has as an owner, creditor, or otherwise may now or at any time hereafter have against the corporation to the claims of all other present and future creditors of the corporation arising out of any manner occurring."

It seems to me that investing your money subject to claims of unknown future creditors and events that will happen down the road is not a risk that a professional investor would take.

Q Youdiscussed with Mr. Beebe this morning whether it had been explained to you in Februray of 1969 whether, I guess it was the back office or books and records problem, I'm not sure which phrase he used, had been caused by the computer conversion.

A Right.

Q Did you learn when you came upon the scene in the summer either through the records of the firm that you might have examined or through personnel with whom you spoke who were present at the time, that while the conversion was being attempted the firm had run a parallel system of record keeping on its already established NCR system?

A Yes. There were two systems in operation. The old manual system, which I understood was deficient, and the new computerized system which was very expensive and I understood deficient.

The analogy given to me was they had the front end of a Rolls Royce and the back end of a Model T.

Q Was the front end, the Rolls Royce, in the testing stage in late '68 and early '69, if you know from your examination of the records or from conversations?

A I would say it was in the testing stage and more. They were testing it and they kept trying to convert certain parts of the work load to it.

Q Do you know what schedule they were on when they converted what part?

MR. BEEBE: I object to extensive testimony

before the gentleman was there. I was blocked in that line of inquiry in my examination.

THE COURT: Is that a basis for competent knowledge of this witness, Mr. Brooks?

MR. BROOKS: Well, the witness hastestified thatwhen he arrived in June or July he did have discussions with employees that had been there in the past and had reviewed some of the records. If he didn't learn this knowledge, he can't answer me. If he did perhaps he can.

MR. BEEBE: I suppose it's also hearsay.

THE COURT: I sustain the objection.

Q Mr. McDonald, you testified that you had received a telephone conversation or you had a telephone conversation, perhaps a meeting with Mrs. Murphy and that she was dissatisfied with the state of affairs at McDonnell & Company, but you weren't sure whether she asked to withdraw her account or not?

MR. BEEBE: I object to the characterization. I don't think that's what he testified to.

MR. BROOKS: I'm just trying to focus the witness. I'll withdraw the characterization.

Q I want to direct you to whatever conversations you had with Mrs. Murphy either on the telephone or in

writing after the time you came to McDonnell & Company. I want to ask you if she ever told you she had been asked to make her subordination in February of 1969?

A My word, I mean words were used. Whether those were among them I can't recall.

Q Can you tell me what she said?

A Can I tell you what she said?

Q In that vein.

A She certainly expressed some doubts, at least, as to whether she had been fully and accurately informed.

Q And what did you say to her?

A Oh, I don't know that there was much I could say to her as to communications given to her before I was on the scene, in some cases by family members. What do you say?

Q How about Mrs. Anna McDonnell, did she ever tell you that she believed she had been defrauded?

A No, sir.

MR. BROOKS: No further questions.

RECROSS EXAMINATION

BY MR. BEEBE:

Q Just one or two questions on this Exhibit 3, Mrs. Murphy's subordination agreement.

Sir, this has a hundred-day withdrawal provision in there of some sort. Do you know if at that time the people who had this kind of agreement could withdraw on a hundred days notice, and by that time I mean August, September 1969? There is also a provision in there about permitting the withdrawal unless the withdrawal will put the company over certain monetary limits.

MR. BROOKS: I think it calls for a conclusion of law by the witness.

MR. BEEBE: He was experienced in that area.

THE COURT: I had thought it called for a statement of whether anybody made an effort to avail themselves of any clauses.

MR. BROOKS: It wasn't that narrow, your Honor. It was more in terms of whether there was such a prohibition against availing oneself of that clause.

THE COURT: Do you want to direct his attention to the clause and ask him what he knows about it?

Q Sir, you were well acquainted with the capital situation of McDonnell & Company in the summer

and fall of 1969, were you not?

A Yes.

MR. BROOKS: Your Honor, I am going to add an objection. I think before we go along this line we first should establish whether any such demand was made. Because if it were not made then I think these questions are irrelevant.

MR. BEEBE: I disagree completely. If there was no purpose in making it, if it would be an empty act. That's the question.

THE COURT: You have to go more than that. You have to prove people knew it would be an empty act.

MR. BEEBE: That's what I am asking this witness.

THE COURT: Let's get down to that.

Q Mr. McDonald, I am trying to find the particular clause. I direct your attention to page 10.

A That's where I am.

Q You are already there.

A I'm glad you found it.

Q I'm glad you found it. And I'll read here:

"Prior to the occurrence of an event of subordination the owner shall have the right at any time,

and from time to time in each instance on at least 30 days prior written notice delivered to the corporation, to withdraw securities from an account if after such withdrawal the aggregate indebtedness of the corporation would not exceed 1500 per cent of its net capital determined in accordance with the capital requirements and regulations of the exchange applicable to the corporation as promulgated by the exchange and in effect at the time of the withdrawal."

We are in the summer of 1969. Could Mrs. Murphy have withdrawn her funds --

MR. BROOKS: I object to the question because that passage Mr. Beebe read is prefaced by the condition prior to the occurrence of the event of subordination. I think we can't answer this in the abstract unless we know there was such an event of subordination.

MR. BEEBE: I'm getting at the 1500 per cent and then we will talk about construction of the instrument in terms of how it functions.

I believe an event of subordination is defined on page 3, your Honor, top of page 3, little "g", to the effect that the company goes bust.

MR. BROOKS: I object to the characterization. I also object to the distinction that counsel

is apparently flying over between withdrawl of securities under an existing subordination agreement, which is the paragraph 7 he is reading, and expiration of the existing subordination agreement, which is where he started, paragraph 1a. I think they are not at all related.

THE COURT: At this point I will overrule the objection.

Are you able to answer that question?

THE WITNESS: Could somebody tell me which question now.

THE COURT: Whether in August of 1969 Mrs. Murphy could have taken her money or securities out under this agreement?

That, I suppose, gets you down to the question of what the capital ratio was.

THE WITNESS: Exactly. All right, I understand.

My answer has to be I do not know. I think that I have said before that we were into some very serious definitional problems since this was an early case in the distress of the Wall Street houses, and we really did not know in some cases what items could be considered capital for 325 purposes and what could not.

We had to presume the most conservative stance. I'm sure that if Mrs. Murphy asked for the return of her investment and it would be very difficult to interpret her attitude as anything else, we had to decline because we weren't sure whether that single act might put us over the 325 line.

Q In any event, you did decline? The company did decline?

MR. BROOKS: I object.

THE COURT: Has there been any showing of a demand?

MR. BEEBE: His last words were that it was hard to interpret her attitude as anything else.

MR. BROOKS: Mrs. Murphy testified she never made a demand.

THE COURT: I seem to recall some proof that could be so construed. In any event, the record speaks for itself and the jury will have to makea determination based on the evidence before it.

Go ahead. Next question.

Q You mentioned after examining the subordination that was tendered to you in 1968 or early 1969 you made the determination that that was a risk that no professional investor would take. You just testified to thaton

Mr. Brooks' redirect examination.

A That was my conclusion.

Q Was it a risk that a non-professional investor should take?

MR. BROOKS: I object.

THE COURT: Sustained.

MR. BEEBE: No further recross.

MR. BROOKS: One question, your Honor, just in this area.

REDIRECT EXAMINATION

BY MR. BROOKS:

Q Look at page 1a of the subordination agreement, where it says:

"The agrement shall expire the hundredth day following the day on which the owner delivers written notice to the corporation demanding termination of this agreement."

A I don't see any 1a, counsel.

MR. BEEBE: He means paragraph 1a, I believe, on page 1.

Q The first page, right about in here (indicating)

Let me read that so we all have it before us.

"Expiration date shall mean the hundredth day following the date on which the owner delivers written notice to the corporation demanding termination of this agreement."

While you were functioning as an officer or consultant to McDonnell & Company, Mr. McDonald, did you ever get such a written notice from Mrs. Murphy?

A No, I don't believe I did.

Q Did you ever get it from Anna McDonnell?

A From Anna McDonnell --

Q In respect to Anna McDonnell's subordination agreement which we come to know has been dated --

A Her own personal investment?

Q Mrs. Anna McDonnell's subordination agreement which is a form almost identical to this and it's in evidence.

A You are speaking of her as an individual and not as trustee of the estate?

Q Yes.

A No, I don't believe we ever did.

Q Did you ever see or hear of such a document being in the records of McDonnell & Company, which document might have arrived prior to your arrival in late June and July?

A No, I don't believe I did.

MR. BROOKS: No further questions.

THE COURT: All right, Mr. McDonald, you are excused.

(Witness excused)

MR. BROOKS: Your Honor, we have now a brief reading from the deposition of Fred J. Stock, who is a deceased officer of the exchange whom we heard about in the testimony. Again Mrs. Solomon and Mrs. Lichstein will do the reading. The deposition was taken by Mr. Dubin a few years ago.

MRS. LICHSTEIN: We are going to start on page 3.

"Q Mr. Stock, will you tell me something about your educational background, starting with approximately graduation from high school.

"A I graduated from Archbishop Stepinac High School, White Plains, New York, and from the Hackley School, Tarrytown, New York. I then graduated from Purdue University in 1960.

"Q What degrees did you take at Purdue?

"A Bachelor of Science and Industrial Economics.

"Q Did you have any further education or

training?

"A I've taken certain other special courses, but none leading to a degree.

"Q What other special courses did you take?

"A Courses in data processing, brokerage accounting, brokerage procedures, that type of course.

"Q Where did you take those courses?

"A Various places. The IBM schools, Pace College, New York Institute of Finance and New York University.

"Q How old are you, Mr. Stock?

"A 35.

"Q When did you first become employed on a full-time basis?

"A July of 1960.

"Q Would you relate to me in a chronological order your vocational background?

"A In July of 1960, I joined the brokerage firm of Dominick & Dominick, in the operations area. I worked through several departments there. And I believe it was January of '65, I went with the Midwest Stock Exchange Service Corporation as a systems representative.

"Q What is a systems representative?

"A A systems representative is responsible for converting broker-dealers to the computerized bookkeeping system offered by the Midwest Stock Exchange Service Corporation.

"Subsequent positions with the Midwest were that of systems manager, and then a vice president.

"Q Is this still out in the Midwest Stock Exchange?

"A Yes, it is. In December of '68 I left the Midwest to join the New York Stock Exchange staff.

"Q In what capacity did you join the New York Stock Exchange in December of 1968?

"A As Assistant Vice President and an Associate Director of the Department of Member Firms.

"Q You said Assistant Vice President and Associate Director of the Department of Member Firms?

"A Yes.

"Q Have you retained those titles to the present, or have you --

"A No, I'm now a Vice President of the Exchange.

"Q When did you become the Vice President of the New York Stock Exchange?

"A About two and a half months ago.

"Q Prior to being made the Vice President of the New York Stock Exchange, you held the titles of Assistant Vice President and Associate Director?

"A That is correct.

"Q What were your duties as Assistant Vice President in the year 1968 and 1969?

"A My primary duties were with respect to the operational and capital surveillance of member organizations.

"Q By capital surveillance, do you mean checking the Rule 325 computations submitted by member firms?

"A Yes.

"Q What were your primary duties as Associate Director of theDepartment of Member Firms during these same two years, 1963 and 1969?

"A The same.

"Q Capital surveillance?

"A Yes."

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"Q Would you tell me who your direct superior was, the gentleman you reported to?

"A Mr. Robert M. Bishop.

"Q Mr. Bishop was Vice President and head of the Department of Member Firms?

"A Yes."

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"Q Is there a procedure now in existence at the New York Stock Exchange, requiring the providing of financial data of a member firm to a subordinated lender, prior to the subordinated lender making the loan?

"A There is not a procedure of the Exchange per se for it to provide data to the subordinated lender.

"Q By procedure, you also include that there is no rule in existence?

"A That's correct. The exchange does not provide any information to them.

"Q I'm sorry, I'm losing you now.

"A I say, the exchange does not provide any information to the potential subordinated lender.

"Q Were you aware in 1969 of the existence of a letter which has been termed a 'knowledgeability letter'?

"A Yes.

"Q Can you tell me the genesis of this type of letter?

"A That letter was required by the exchange

in certain instances to dispel the potential lender from any possible belief that he has a form of protection from the exchange in conjunction with his capital contribution.

"Q Do you recall when the use of knowledgeability letters first came into existence?

"A I would think the first ones were required some time in '68 or 1969, on a selective basis. In 1970, such language became incorporated in our standard agreements.

"Q In the standard subordination agreements; is that correct?

"A Yes.

"Q Did the New York Stock Exchange draft suggested forms as to the subordinated loan agreement?

"A In what period of time?

"Q 1968, 1969.

"A There was a general form that was used by the majority of member organizations. However, they did not have to specifically use that form.

"Q Could the member firm use its own form and seek approval ofthe New York Stock Exchange as to the type of subordination agreement being used?

"A Yes.

"Q And that was followed in many instances, I take it?

"A In some instances, yes.

"Q You mentioned a few moments ago that the use of knowledgeability letters was required on a selective basis. Can you tell me who made the decision as to what member firms having subordinated lenders would have knowledgeability letters issued?

"A That decision generally would come from one of three sources: Mr. Bishop, myself, or the coordinator for the member organization."

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"Q Do you know who the coordinator was for the firm of McDonnell & Company during the year 1969?

"A I believe during the year of 1969, there was more than one coordinator for the firm.

"Q I believe one of them was Mr. George Newman. Would that be correct?

"A I believe Mr. Newman became the coordinator some time during 1969.

"Q Do you know who was his predecessor?

"A I believe it was Mr. Schuette.

"Q Mr. Herbert Schuette?

"A Yes.

"Q You mentioned that in addition to the coordinator, it was Mr. Bishop or yourself who chose what firm should issue a knowledgeability letter; is that correct?

"A Yes.

"Q Do you recall, as it relates to McDonnell & Company, informing McDonnell & Company that they were required to issue knowledgeability letters?

"A I don't specifically recall.

"Q Can you tell me what criteria you used in determining what member firm should issue a knowledgeability letter to its subordinated lender?

"A There were not specific criteria. It was a

matter of judgment.

"Q And in this judgment, you would take in all the aspects as to the financial and operating conditions existing in the member firm?

"A Among other things, yes.

"Q What would be the other things you would consider?

"A I think another consideration would be who was the party contributing capital.

"Q By that you mean the degree of sophistication of the party?

"A The degree of sophistication, the degree of closeness to the member organization.

"Q Do you recall approving a subordinated loan for the firm of McDonnell & Company during any part of the year 1969?

"A I recall that there were capital infusions approved by the Board of Governors during 1969.

"Q That's the Board of Governors. Do you recall yourself having seen applications for subordinated loans to McDonnell & Company, in your capacity as Associate Director and Assistant Vice President?

"A I don't recall having seen specific applications or subordination agreements in that period myself.

"Q I believe you said something to the effect of

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depending on who the person is, as to the subordinated loan, and I believe I mentioned to you the degree of sophistication. Is there any other aspect that you can tell me about as to when you would choose to have a knowledgeability letter issued?

"Mr. Brooks: Mr. Stock has told you of some other factors, Mr. Dubin. You mean other than those other factors?

"Q You said degree of sophistication was one aspect. Could you tell me other ones?

"Mr. Brooks: He already has told you other ones.

"Q Would you be kind enough to tell me again?

"Mr. Brooks: No, he won't tell you again. We only answer the same question once."

Then there was an objection, and then follows this question:

"Q Would you define what you mean by 'degree of closeness'?

"A By 'degree of closeness,' I would mean primarily is the capital contributor himself a member or allied member of the organization, or a member of his immediate family.

"Q What difference would that make to you in your determination?

"A Well, the members and allied members, particularly

those who are principal executives of the organization, as well as their immediate family, we felt were more likely to know all of the material facts about the condition of the organization than, say, some customer who has an account there, and who has been asked to subordinate his account, and has absolutely no other relationship with the firm.

"Q Did you make an investigation to determine for yourself whether the proposed subordinated lender had indeed been informed of the financial and/or operating conditions existing at the member firm where the proposed subordinated loan was to take place?

"A No, we did not.

"Q But you did make a differentiation in your mind as to the type of person making the subordinated loan?"

There was a discussion and then another question was asked:

"Q You did make the differentiation in your mind? You said degree of closeness--

"A This was one of the factors that was included in our judgment as to whether or not we should request a letter.

"Q The letter we are talking about, the knowledgeability letter, can you define exactly what, in substance, that letter stated?

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"A In substance, it stated that they have made whatever review of the financial and operational condition of the member firm they deem is appropriate; the fact that they are not looking to the Exchange, its officers, governors, special trust fund, for any information with respect to the firm, or any protection for their investment.

"Q You have now named two criteria, that being the degree of sophistication and the degree of closeness, and you defined what you mean by degree of closeness. Were there any other criteria that you had in mind?

"A I believe I also stated it was the financial and operational condition of the member organization.

"Q And you had determined the financial and operating condition of the member firm how?

"A Based upon the information which the Exchange had on the firm.

"Q Would you look to the last financial analysis of the member firm's capital ratio, or did you look to the past record for the member firm for the past year, or what analysis did you make as to the financial and operating condition?

"A We probably looked at the most recent data we have."

MRS. LICHSTEIN: Page 79:

"Q Have you had, during the year 1969, conversations

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or correspondence or meetings with any member of the Securities & Exchange Commission in relation to the firm of McDonnell & Company?

"A Yes.

"Q Would you tell me whether it was a correspondence?

"A I don't believe I had any correspondence with the SEC staff.

"Q Did you become aware of correspondence to the SEC staff?

"A During 1969?

"Q That's correct.

"A I believe there was correspondence between the Exchange and the SEC.

"Q Do you know who at the Exchange initiated or was the recipient of these correspondence?

"A Not specifically.

"Q Did you have conferences with members of the SEC staff as it relates to McDonnell & Company?

"A At the moment I don't recall any specific conferences as it relates to McDonnell & Company.

"Q Did you have conversations, phone conversations, with members of the SEC staff as it relates to McDonnell & Company?

"A Yes.

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"Q Who did you have these conversations with?

"A I've had conversations with Mr. Barton.

"Q Joseph Barton?

"A Yes.

"Q Of the New York Regional Office of the Securities and Exchange Commission?

"A Yes.

"Q Who else?

"A I may have had conversations during that period with Messrs. Duffy, Sporkin & Pollack.

"Q Those would be members of the SEC staff in Washington?

"A Mr. Duffy was in New York.

"Q Mr. Sporkin and Mr. Pollack are Washington SEC staff members?

"A Yes.

"Q Do you recall the substance of your conversations as to McDonnell & Company with these gentlemen you just mentioned?

"A It would be a general discussion of the condition in the firm, as we knew it to exist at that particular moment in time.

"Q Were you aware, during the year 1969, of an investigation of the firm of McDonnell & Company by the

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Securities & Exchange Commission? Were you made aware of such an investigation?

"A I am aware that there was such an investigation. I'm not sure if I was made aware of it during 1969 or 1970.

"Q Do you recall what the substance of this investigation as to McDonnell & Company consisted of?

"A As I recall, its initial focus was on compliance with Regulation T.

"Q Do you recall whether the investigation included anything besides the investigation of Regulation T?

"A I believe that ultimately it included books and records and capital, as well as Regulation T.

"Q Did you, during the year 1969, ever ask anyone at the Securities & Exchange Commission to defer their investigation of McDonnell & Company for any reason whatsoever?

"A I would say no.

"Q Are you aware of any other person at the New York Stock Exchange who asked the Securities & Exchange Commission to defer their investigation of the firm of McDonnell & Company during the year 1969?

"A I don't recall anyone so requesting.

"Q Was it a policy of the New York Stock Exchange to ask the Securities & Exchange Commission to defer an

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investigation of a member firm while the New York Stock Exchange had its own investigation of a member firm presently in existence?

"A I don't think there was a policy to make such a request per se.

"Q Do you know of any instance where the New York Stock Exchange asked the Securities & Exchange Commission to defer the Securities & Exchange Commission investigation in light of the fact that the New York Stock Exchange was investigating one of its own members?

"A During 1969, there were certain cases dealing with the books and records rules of the Exchange and of the Commission, where the Exchange had discussions with the SEC staff to the effect that the Exchange was planning to bring disciplinary action, and that there may not be a need for the Commission staff to commence an action.

"Q Do you recall that in relation to the firm of McDonnell & Company?

"A Not specifically. It's possible that there were such discussions."

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The testimony that we are going to now read refers to an exhibit already in evidence as Exchange Exhibit GG.

"Q Please look at Plaintiffs' Exhibit 66 and tell me whether you have ever seen this document before.

I also direct your attention to the bottom handwritten notation.

"A I have seen this memorandum before.

"Q The memorandum is dated April 7, 1969. The handwritten notation is dated April 17, 1968, with the statement, 'Meeting of R.M.B.,' which is Mr. Bishop, 'F.S.,' which is you, Mr. Stock, 'and T. Murray McDonnell. No restriction imposed.' The signature below that is that of Mr. Schuette.

Can you tell me the substance of the conversation between Mr. Bishop and Mr. T. Murray McDonnell and yourself regarding the imposition of restrictions?

"A The basic substance was what steps the firm was taking to correct their problems, as well as the self-imposed restrictions that they have put on their business.

"Q I believe your testimony concerning Plaintiffs' Exhibit 64 was that you had recommended imposition of restrictions at that meeting. That document speaks of April 2, 1969.

Can you tell whether you, first of all, agreed with not imposing restrictions as of April 17, 1969?

"A I did.

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"Q Can you tell me what changed your mind, within the 15 days, as to why restrictions should not be imposed?

"A The steps outlined by the management of McDonnell & Company.

"Q Did you incorporate McDonnell & Company's voluntary restrictions as the New York Stock Exchange restrictions?

"Mr. Brooks: I don't understand the question.

"Q Do you, Mr. Stock?

"A I'm not sure that I understand it.

"Q Is there a procedure whereby the New York Stock Exchange can treat a voluntary restriction as its own restriction?

"A Yes.

"Q Did you treat the voluntary restrictions of McDonnell & Company as if they were imposed by the New York Stock Exchange?

"A No.

"Q Do you recall what restrictions Mr. McDonnell imposed upon himself that changed your mind within the 15 day period?

"A I did not state that iw as solely the restrictions which he imposed which made me change my mind.

"Q Would you tell me what other criteria changed

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yourmind within the 15 day period?

"A The other various steps that were taken in addition to the self-imposed restrictions.

"Q What are --

"A Were a contributing factor.

"Q What are the other steps taken?

"A As I recall, they had retained consultants and research people to help resolve their problems. I believe they had their auditors working on the situation with them. One of the things that was presented was the introduction of Mr. O'Brien as the president of the firm, to better manage the affairs of the company.

"Q Do you recall whether Mr. O'Brien, in your opinion, was qualified to be president of a member firm of the New York Stock?

"The Witness: Do I get sued for libel if I answer?

"Mr. Dubin: No.

"Mr. Brooks: Not by Mr. Dubin.

"Mr. Dubin: Not by me, and also it is privileged information in a lawsuit.

"A I really had no basis on which to determine whether or not Mr. O'Brien was qualified to manage a-- be president of a member organization.

"Q Do you know whether Mr. O'Brien had any experience

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whatsoever in the securities business?

"A I don't believe Mr. O'Brien had experience in the securities business. However, he had had considerable managerial experience.

"Q You had mentioned as one of the criteria that changed your mind within this 15 day period, the aspect of McDonnell imposing self-restrictions. Do you recall what self-restrictions were imposed by McDonnell?

"A Among the self-imposed restrictions that I recall were they had discontinued advertising and other promotional activities. They were not opening any new offices. But certain limits on the types of securities that they would let their customers trade in. Put certain restrictions in on minimum margin required for new accounts. Items like that."

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"Q Do you recall informing the Securities & Exchange Commission of a violation of Rule 325 by McDonnell & Company during any time of the year 1969?

"A Informing them?

"Q Yes, sir.

"A Or violation during the year?

"Q Informing them of a violation. You have learned, as your testimony has revealed, that you were aware of the

October 31, 1968 violation, the January 30, 1969 violation.

"A Is your question, though, did we inform them in 1969?

"Q That's correct.

"A I would say we discussed the fact that there had been a violation or violations, during 1969, with the SEC.

"Q Do you recall who you discussed this violation with, or violations?

"A I would say Mr. Barton, Mr. Duffy, Pollack and Sporkin.

"Q Do you recall any one of these gentlemen in particular, or it could have been any one of them?

"A Those are the gentlemen with whom I frequently had discussions on similar situations."

MRS. LICHSTEIN: We are finished, your Honor.

MR. BROOKS: I would call as the next witness Robert M. Bishop.

R O B E R T M. B I S H O P, called as a witness, having been duly sworn, testified asfollows:

DIRECT EXAMINATION

BY MR. BROOKS:

Q I will ask you for the record, Mr. Bishop, by

whom are you employed?

A The New York Stock Exchange for 20 years.

Q In what capacity are you presently employed?

A Senior vice president.

Q What are your duties in the office which you now hold?

A I supervise all regulation by the Exchange of its member firms and the floor of the Exchange.

Q Is that where the actual trading goes on of securities?

A Yes.

Q Can you tell me what your educational background has been?

A I am a graduate of Union College in Schenectady with a Bachelor of Arts degree in American civilization; I have a Master's degree from Trinity College in Hartford in public service; and I was an Air Force pilot and went through their educational program; and then I have had education in securities at the Exchange.

Q Did the Master's course which you took require a thesis?

A Yes.

Q Did you write one?

A Yes.

Q What was the thesis?

A The public service function of the New York Stock Exchange.

Q Did you have employment other than the service before your Air Force days?

A Yes.

Q What was that?

A I was assistant director of public relations at Union College for two years. Then I was director of public relations at Trinity College for eight.

Q And then came the service?

A No, the service came in between my graduating and my working for Union.

Q Was that World War II, sir?

A Yes.

Q Where did you seek employment when you finally left the campus?

A The New York Stock Exchange.

Q And in what capacity?

A In 1955 I became assistant to the president.

Q Would you trace your career briefly between 1955 and 1969, just tell us the offices you held and generally what that meant and what you did in those offices?

A In 1960 I went into regulatory work as associate

director of what was called the Department of Member Firms liaison. I really went in order to build a new examination system for registered representatives, the people who sell securities. The exchange conduct examinations when people become registered representatives in order to make sure that they arewell qualified.

That also had member firm relations activities, and I was engaged in those activities for about two years.

Then I went pretty much full time into regulation as associate director of the Department of Member Firms, of which the member firms liaison department had been a section.

And in 1963 I became a vice president as well as associate director of the Department of Member Firms, and also immediately I started directing the department since the director had a heart attack, but he didn't retire until 1965 when I firmly became director of the Department of Member Firms and continued being that until I think about a year and a half or two years when I became a senior vice president, and then took on the additional duties of regulating the floor of the exchange. Previously I had just been regulating the member firms.

Q Do you still regulate member firms?

A The staff under me does, yes.

Q I take it in 1968 and 1969 you were the head of the Department of Member Firms, and that department had regulatory jurisdiction over McDonnell, is that true?

A That's true.

Q What kind of legal entity is the stock exchange, sir?

MR. BEEBE: Objection. I think we should go back to the time period involved.

MR. BROOKS: We do plan to take that trip, your Honor, but we thought we would start here.

MR. BEEBE: The present structure of the exchange is irrelevant. What they were at the time is, of course, what matters.

THE COURT: If it's only a matter of relevance, let's get a little background.

Overruled.

BY MR. BROOKS:

Q What kind of legal entity is the exchange?

A I think what is called a nonprofit corporation under New York State law.

Q Let's take Mr. Beebe's question, sir. Where did it all start? Give us just a brief sketch of the history of the New York Stock exchange from where it started to where it got to be a nonprofit corporation.

A Okay.

The stock exchange started sort of informally in 1792 when there weren't many securities in the United States; they were mostly government securities, and some people sometimes wanted to sell them to somebody else.

And so merchants who were storekeepers started doing this as an extra function, and eventually they saw the desirability of getting together once a day, and they started meeting under a buttonwood tree in Wall Street at 11 o'clock in the morning to trade in these government bonds, and they formed a constitution to govern this trading. It, for example, contained a clause that they would promote just an equitable principles of trade among their members, which is still the first article of the exchange's constitution.

Well, this enterprise grew over the next 150 years and became quite large. It had many different securities listed.

As the country grew, the canals and the railroads and then the industrial companies in the last century, as they became large and needed to be traded in a central market, they were traded on the exchange, and it got to the point where the exchange was trading every security simultaneously on its floor all day long, and that is what

has been going on for the last 75 years or so.

In 1934, of course, the Securities Act of 1934 came along and gave us a somewhat different legal being, in that that act of Congress gave us a responsibility for regulating our members; you know, it became a matter of law. Previously it had only been one of our own constitutio but we carried on doing most of the same things that we had previously developed in regulation.

Now -- I guess I am taking too long -- by the time we come up to this 1968, 1969 period, we were what we had become over those years, and we were still what we had started out being, an unincorporated association of members as far as the kind of legal entity that we were then.

Q After the passage of the Securities Exchange Act of 1934, did the exchange acquire a supervisor?

A Yes, we did.

Q Who was that?

A The Securities and ExchangeCommission. It took a year or two to get organized, but it was pretty effectively functioning by the time we got to this '68, '69 period.

Q As you went about your business as the head of the Department of Member Firms did you from time to time encounter the supervision by the Securities and Exchange Commission?

A Yes. I considered that we were co-workers doing the same work.

Q I take it you in turn supervised the member firms of New York Stock Exchange?

A Yes.

Q Did the Securities and Exchange Commission do the same thing?

A To some extent. They looked over our shoulder at what we were doing and did some supervision in areas that we didn't do much in. For example, the underwriting area, they would look at what member firms were doing in that. Or if they had some reason for

doing so they might do the same thing we were doing.

Q Let me ask in common terms, Mr. Bishop, your understanding of the scheme of regulation. Could you put a member firm out of business if proper showing was made?

A Yes.

Q Could the Securities and Exchange Commission put a member firm out of business if a proper showing were made?

MR. BEEBE: Objection to relevance.

THE COURT: Overruled.

A Yes.

Q Could the Securities and Exchange Commission put the stock exchange out of business if a proper showing were made?

MR. BEEBE: Same objection.

THE COURT: Overruled.

A Yes.

Q Tell me about the exchange, in about January '69, who were members of the exchange first of all? Let's start with that.

A Well, we have people whom you probably heard about as having seats on the stock exchange. They are the members. They are individuals. By

provisions of our constitution, there are just 1366 seats.

Originally they were chairs where you sat in a room to trade. But by the time this period came along it was just the right to go on the floor physically and make a trade in the trading crowd. There were only 1366 such opportunities. If you wanted to become a member of the exchange you had to purchase this privilege from somebody else who was leaving for some reason or other.

These people were the members.

Q While you are on the subject of purchasing those seats, Mr. Bishop, do you recall what one of those seats was selling for in and about June of 1969?

A About $400,000.

Q Now, how do you get from a member, which is a live person walking around and sitting in these seats once in a while, and a member firm? What is the relationship between the two?

A If a member is associated with any securities brokerage firm, that firm has to be a member firm. And if it doesn't qualify for being a member firm, then the member has to leave it. Therefore, a member firm gets to ge a member firm first by having a member

associated with it, and second by being approved by the exchange as a member firm. In order to be a member firm it has to agree to abide by the constitution and rules of the exchange, to have all of its people subject to the regulatory jurisdiction of the exchange. We are able to put any person out of the firm with due showing. And they have to have certain types of people qualified with us in the kinds of examinations and other things that I mentioned a few minutes ago.

Q Do those people who are approved as officers or partners in member firms enter into any kind of an agreement with the exchange to abide by the rules?

A Three categories of such people do. First the members. These agreements are all similar. Second, what we call allied members. They are the other general partners or voting stockholders in member firms in the period we are talking about. In general, these people were principal executives in the firm.

Now, it was also possible to be an officer of the firm, say a vice president, without being an allied member and a voting stockholder. But practically all the officers of the firm were also allied members.

The third category were what we call

registered representatives. They were the people who were not allied members but who service customer accounts. If you wanted to buy or sell a security, they are the ones who would give you advice on doing it and take your order, see thatit got put in properly, take care of relationships with you. They are registered representatives.

Q I take it from your explanation member firms can be both corporations and partnerships?

A Yes. Prior to 1954 they all had to be partnerships. But beginning in 1954 they could be corporations as well.

Q What is the equivalent of a partner where the member firm is a corporation?

A In this period it was a voting stockholder. We had two kinds of stock, voting and non-voting. The people who ran the firm owned the voting stock, and the people who were not in the firm or who weren't important enough for the firm to judge that they were in the top running group had non-voting stock.

Q Now, would the people who have voting stock have to be approved by the exchange?

A Yes.

Q What would they be? Would they be members

or allied members?

A They would be allied members.

Q Let me show you --

A They could also be members.

Q Let me show you Exhibit 13, which is the application for allied membership of James F. McDonnell, Jr., sir, and ask you if that is the type of agreement that you referred to before when you said an allied member agreed to abide by the rules, and so forth?

A Yes. It says so right in a little paragraph here.

Q Thank you.

THE COURT: Would this be a good time for a recess, Mr. Brooks?

MR. BROOKS: Yes, your Honor.

THE COURT: We will recess then.

(Recess)

(In open court; jury present)

BY MR. BROOKS:

Q Can you tell us the basic divisions or departments of the stock exchange in and about 1969?

A We had a floor operations department which provided the clerks and coupon men and personnel who helped members run the floor. We had a stock list

department having to do with the listed companies and listing stocks on the exchange.

Q Is a listed company something like General Motors or ATT?

A Yes. All of the companies whose stock we trade in, or bonds.

We had my department, the department of member firms. We had our stock clearing corporation which has to do with exchanging the money in securities four days after the trade is made on the floor. What we call settling the trade. I believe we had the beginnings of our depository trust company, which is now a bank subsidiary which holds customers securities in the names of the firms with whom they are on deposit. And then we had the usual kinds of things that any corporation has or any business enterprise, like the treasurer's office and controller's office and a personnel department and a building company that has the cleaning people and runs our building, and the guards.

I think they are the major ones. Maybe I have forgotten someone.

Q I think you have gone far enough for our purposes.

A The floor department then had two parts.

It had floor operations, which I described a minute ago. Then it also had floor regulations. That was a separate section.

Q We have had introduced as Plaintiffs' Exhibit 34 the New York Stock Exchange constitution and rules. Does that constitution and those rules have to be approved by anybody other than the stock exchange before they are affected?

A Well, the word "approved," I think you are correct in a sense in that they originally had to be filed with the Securities and Exchange Commission and they had to find that for certain things expedited in the '34 Act that our rules were adequate. So that in that sense they approved them.

Then beginning sometime in the late '60s, and I don't remember the exact date, we had -- well, before that we had to file any changes in our rules with the SEC once a year, we have to make sort of a resubmission of our constitution and rules at the beginning of each year with any changes.

Then sometime in the late '60s we had to start filing proposed rule changes with the SEC I think three weeks in advance of our being able to have the board of directors approve them. There was a provision

for emergency action to shortcut that procedure, but it's hardly ever used.

Q Which of the rules and which of the provisions of the constitution did you work with in supervising the member firms that you had charge of in and about January of 1969?

A Well, there are a great many. It must be about half of the rulebook which is about this thick (indicating). And up at the top of each page in the constitution and rules there is alittle line that says who is responsible for supervising the rules on that page, and on ours it says department of member firms.

It's basically all the rules having to do with the books and records of member firms, their financial responsibility, their conduct in sales activities in their offices around the world, supervision of firms, and that type of thing.

Q How many employees were there in the department of member firms in and about January of 1969 to supervise the application of these rules?

A Around 250.

Q Tell me what tools or methods you would use to supervise the average member firm that did business with the public such as McDonnell?

A Well, we had our department divided up into sections, which each had its own techniques.

Would you like me to try and cover the whole scope or some part of it?

Q Well, we have heard lots of testimony about an audit here. Why don't you start with the role that an audit played in the supervision by your department of member firms and perhaps work from there and tell us what other kinds of reporting tools or devices you had, what methods you had to inspect on your own and we will move on from there.

A I guess this would come in the area of financial and operational surveillances as contrasted to sales surveillance, which we had somewhat different techniques for.

In the area of financial and operations surveillance both our rules and the SEC's rules were parallel in this respect: that we both required that each broker-dealer doing business with the public have an audit each year by an independent public accounting firm.

We and the SEC, our rules were identical in this respect, and we each required what the auditor should do in that audit. And as compared with the

usual industrial audits, we required them to be much more thorough. They had to, for example, what we call requests for confirmation to every customer with whom the firm had an open securities account and to every broker-dealer that they had an open securities account, and to every bank for every security and every loan in the bank, and every transfer agent.

Now, in many other types of businesses, the auditor would be permitted to only send to a sampling of his own choice. He would decide how much of a sampling needed to be made.

At any rate, and maybe I'm getting too detailed, the audit was one tool and the auditor had to fill out a questionnaire based on the audit which was submitted to the SEC and the exchange.

Q Let me show you Exhibit Z, which is the report or the answers to financial quesionnaire submitted by Lybrand, Ross Brothers & Montgomery for McDonnell & Co. as of October 31, '68.

Is that the end product of the audit you have been describing?

A Yes. Do you want me to go on?

MR. BEEBE: I think he should finish his answre.

THE WITNESS: I finished it on that question.

THE COURT: Put your next question, Mr. Brooks.

Q Now, did you have any other reporting devices similar to the audit done by the accountants?

A Yes.

Q What were they?

A This came in once a year and we wanted to know more frequently similar information. So we had another form of questionnaire which the firm had to fill out itself whenever we asked for it.

Now, it was our usual practice to ask for it twice a year and we divided the year up into four-month periods. The auditors would tell us confidentially what month they were going to make their audit in or what third of the year. Then we would send questionnaires to the firm in the other two thirds.

If we wanted to we could also ask them to do it more frequently, but normally we just got three a year.

Q You mentioned that the --

A I think I should add to that that in order to have some assurance that the firm was being honest in reporting to us, we had our own staff of examiners

who would go into the firm occasionally, usually once a year, and take one of these questionnaires that the firm had submitted along with them and look at the firm's books and records and see if what was reported to us on the questionnaire was accurate.

Q Let me show you Plaintiffs' Exhibit 28, which is Mr. McElroy's report of McDonnell Company dated April 24, '69.

Is that the end product of such a visit that you described as having been part of your program and undertaken by examiners?

A Well, it's yes and no. This one, it says "Limited examination visit," is the title. It means that he apparently was not doing everything that he might have done if he had gone in on one of these routine visits.

In this case he was looking at what the auditors had reported as of October 31, 1969 --

Q '68, sir, isn't it?

A You are correct. And that he was also looking at a questionnaire submitted by the firm as of January 30, 1969. So he was looking at two of them.

Q You mentioned that the SEC's audit rule and the stock exchanges were the same or were parallel.

Does the SEC have a capital rule?

A Yes, they do. Maybe I ought to modify my previous answer a little bit. We did have something beyond what the SEC had, and that is we required the audit to be on a surprise basis at the time; the SEC did not.

Q Does the SEC have a capital rule similar to the capital rule that we have heard discussed in this case fairly often, rule 325?

MR. BEEBE: Your Honor, excuse me. I am going to object to questions about the SEC in the sense that the New York Stock Exchange is here on trial and not the United States Securities and Exchange Commission.

THE COURT: On that ground I will overrule it.

You may answer, sir.

A Yes, it's similar.

Q Does the SEC's capital rule apply to New York Stock Exchange member firms?

A No.

Q Why is that?

A The SEC's capital rule has a provision in it that allows the SEC to exempt members of national securities exchanges from the SEC's capital rule if the

SEC finds that the exchange's capital rule is -- I can't remember the exact words, but it means more comprehensive or more difficult than the SEC's capital rule.

MR. BEEBE: I should press an objection that the rules themselves are the best evidence of what the rules provide, if there are further questions along this line.

THE WITNESS: I would like to add to my answer there is a paragraph in the SEC rule that lists the exchanges that are exempted as having been found to meet the defendant, and we are one of the exchanges that are exempted as having been found to meet the test, and we are one of the exchanges listed.

Q Let's move on to the other tools that your department used in January 1969 to keep track of its member firms. Were there any other reports that a firm was required to submit on a periodic basis?

A In 1969?

Q Yes, about January, February.

A I can think offhand of two more. One was we started something called a fails report. I think maybe we started thatin 1968, which was a monthly report on a kind of incomplete transaction called a fail,

and the total number of those or total dollar value that firms had in different categories.

Then we had another report called a special operations questionnaire which gave a little bit of financial information but it mostly gave information that permitted us to estimate what the books and records condition of the firm was, whether they were in good order or not. We started that in 1968. That was required of all firms quarterly and of quite a numberof firms monthly.

Q Can you tell me of the genesis of the special operations questionnaire? You said it started in 1968. Why did it start and how was it designed?

A How was it what?

Q Designed.

A Well, when the volume of business handled by member firms reached the point where their staffs and their systems were being overtaxed and more than normal errors started to creep into the member firms generally, we decided we needed some new technique for being more current and for identifying just which firms and in what departments of the firms unsatisfactory conditions might be arising.

And the financial questionnaires didn't give

us enough detail in that respect and they weren't frequent enough. So we assigned some of our examiners to sit down and write a questionnaire that would develop more operations type information, and that's what these special operations questionnaires were. It was written in, say, March or thereabouts of 1968 and put into use immediately.

Q What about profit and loss information from member firms, did you receive that?

A We got that once a year in what were called the income and expense reports which were primarily designed in connection with -- the exchange also established commissions which all member firms had to charge on listed securities trades,and this was designed primarily to allocate the costs and revenues of a securities firm to the commission business as opposed to the other types of business that they did.

Q I guess the principle that would be applied would be that big money makers pay the most because they have a percentage of their commission that goes to the exchange?

A You are talking about registered representatives?

Q Well, you said you want to keep track of

their commission business?

Q Yes.

A Because we had some special duties in that respect. Most businesses aren't permitted to charge the same prices that other businesses do in cooperation with the others. Macy's and Gimbels can't get together and decide to charge the same price. But stock exchange firms could, and the stock exchange set those rates with the supervision and approval of the SEC. And that is the reason that we got this information.

Q Part of your regulatory function?

A Yes.

Q Now, suppose a customer of a member firm out in DesMoines has a complaint. Can that complaint get a favorable reception at some office of the exchange?

A Yes. We had a complaint division under me where all such inquiries and complaints from customers coming anyplace to the exchange were all funneled into this division who would look into it and correspond with the customer.

Now, I guess I haven't gone quite far enough three. We also had another place. We had an arbitration facility where disputes that couldn't be readily resolved were heard by, in effect, a jury.

It's sort of a small court procedure, less formal than courts, called arbitration but authorized under New York State law for settling disputes between customers.

MR. BEEBE: Sir, could I suggest we move from DesMoines to New York and bring things a little closer to the facts at hand?

MR. BROOKS: I am just about to, your Honor.

Q Could a subordinated lender avail himself of your inquiry and complaints department or your arbitration facilities if they felt they had a grievance against a member firm?

A Yes.

MR. BEEBE: Objection to relevance.

THE COURT: How is this relevant?

MR. BROOKS: As I understand the complaint against the exchange, it's being charged with failure to properly regulate.

MR. BEEBE: In part.

MR. BROOKS: If there is a facility available which someone who feels he's aggrieved has not taken advantage of, it's relevant to that claim.

MR. BEEBE: I'm not sure how even mentioning that kind of question can pertain at all to the question here.

THE COURT: I think I'll overrule that objection.

A Yes, they could. In fact, many grievances provided that the dispute should be arbitrated.

Q Do you know from time to time that subordinated lenders do avail themselves of these facilities?

A Yes, they do.

Q Mr. Bishop, as you no doubt know there has been a lot of controversy in this case about the New York Stock Exchange capital rule, rule 325. Could you tell me what the objective of that rule is?

A Well, its objective arises from the experience of the stock exahcnge, and I think it was originally written in the 1920's and has developed since, where it really has two objectives.

One is to make sure that firms have enough cash to meet the needs of paying out customers and paying other brokers, and so forth, in the normal course of their business. We call that the liquidity aspect of the rule.

Its second objective is to bring some harmony between the amount of capital that we require a firm to have -- here I use the word "capital" as being their net worth, as we use it -- in comparison with

the risk and the kinds of business they engage in. And to give you an example of what I am talking about, if they make markets in securities and consequently buy securities and have positions in them in connection with their business, they do underwritings where they are buying security positions, we do not allow those security positions at full value as shown by the market; instead we discount them by the amount which we think they would decline under severe conditions. We call that a haircut. For common stocks like American Telephone, it's 30 per cent.

Q During this period would you be in agreement with the statement that the rule provided a maximum capital ratio of 2000 per cent from member firms?

A Yes.

Q Did the department of member firms or other responsible officers of the exchange have the authority to grant an exception to that rule?

A Yes.

Q Did the same officers have authority to make a more stringent requirement on a particular member firm?

A Yes.

Q Did you during this '68 and '69 period have occasion to make judgments in respect to what was good

capital and what was not good capital under the capital rule?

A Yes.

Q Was that unusual?

A No.

Q We have heard a lot of talk in this case about stock record differences. Can you tell me whether stock record differences would be an example of a problem on which you had to make a judgment in '68 and '69 in respect to the capital rule?

A Yes, they were that kind of problem.

Q Will you explain what the problem of a stock record difference was and what kind of judgment had to be made and what the considerations were?

A Well, whenever a bookkeeping error is made in the accounting for the securities held by a firm as opposed to its cash, that error would likely be reflected in its stock record, which I think you have heard before is a list showing on one side what stocks they are supposed to be holding for what customers and on the other side where the stocks are supposed to be.

So if an error is made, for example, if McDonnell & Company -- if I was a customer of McDonnell

and if they had mailed the stock out to me and they didn't note that in their records it would show me as still owning a stock but yet they have mailed it to me so they would be short on their records, although they weren't really short but their records would show that they needed the stock for me that they didn't have.

All kinds of errors flowed through into the stock record, and the question was whether we should impose a capital charge on a firm in respect to those errors. That was a kind of question that came up every now and then.

Q Why hadn't this question been settled long ago?

MR. BEEBE: Objection. We don't know that it wasn't settled long ago. There is no foundation for thatquestion.

THE COURT: Let's lay the foundation.

Q Mr. Bishop, I take it from your testimony that you were required to make judgments about stock record differences in '68 and '69?

MR. BEEBE: Objection. Thatwas not his testimony.

THE COURT: Overruled.

Q Is that correct?

A Yes.

Q Well, can you tell me why there had not been developed a settled practice or a provision of the capital rule to cover stock record differences?

MR. BEEBE: Objection to form and foundation.

THE COURT: Overruled.

A It came up infrequently. On the few occasions that it did come up earlier, we had made decisions which gave us an experience for the new questions that were to come.

Q Did it come up more frequently in 1968 and 1969?

A Yes.

Q Why?

A Pardon?

Q Why?

A Well, formerly the bookkeeping errors were not in large enough quantity to be significant. The stock record differences had been relatively isolated.

I can remember maybe two or three in the early parts of the '60s, but you know, I suppose a couple of hundred firms at least had large stock record differences in 1968 and 1969. It was a general industry problem.

Q Tell me what judgments you made with respect to the treatment of stock record differences as good capital or not as good capital.

A Well, our experience had been in going through these instances that we had had occasionally previously that the errors would get corrected and there would be no actual loss, so that we ordinarily did not charge short stock record differences to the firm's capital.

Q Let's try to set the scene a little better before we go further, Mr. Bishop.

Who was your immediate superior in 1968?

A Mr. Arning.

Q And who was immediately below you in the chain of command?

A In this area, Mr. Stock.

Q So with respect to McDonnell & Company, would a coordinator be below Mr. Stock?

A Yes.

Q We know that Mr. Schuette was one coordinator succeeded by Mr. Newman.

A Yes.

Q Let's suppose that a firm violates one of the rules that you have jurisdiction over, a record keeping rule or a capital rule, what did your department do in 1969 when that was discovered?

MR. BEEBE: Objection. Hypothetical.

MR. BROOKS: I am just trying to get the general practice your Honor.

THE COURT: Overruled.

A First we had to decide whether we thought it was a significant violation. With the complexity of our rules and detail it's hard for people not to have some departures from it in the ordinary course that are just normal, but if we thought that it was a significant violation then we would set about seeking to bring disciplinary action against them, which we would do by drawing up a charge memorandum

and submitting it to an appropriate body.

Q What do you do about that violation there that's in existence? Do you do anything to correct it?

A Oh, well, if it was something serious, yes, we would get it corrected first before we addressed ourselves to the disciplinary possibilities.

Q Is the violation of the capital rule such an event?

A Yes, it is, always.

Q And record keeping rules?

A Yes. It depends on the record keeping rules and how serious they were.

Q Did the rules themselves besides the capital rule provide for any penalty when there is a violation?

A No.

Q How about the record keeping rule?

A No.

Q Does it say if you have got a bad book and a bad record you get such and such penalty?

A No, it does not.

Q How does the penalty work? How do you decide who gets what for what?

A Well, there is a provision of the constitution that provides that for violations of rules, censures, fines or suspensions or expulsions may be imposed after due process.

Q What do you mean by due process?

A The same sort of thing we are going through right here in this courtroom, namely, giving the person who is said to be at fault an occasion to know exactly what he is charged with through a written charge memorandum; then giving him an opportunity to reply to it in writing; to permit him to appear at a hearing and confront the people who are charging him and the witnesses, and questioning them, just as is being done here. And then some competent body comes up with a decision just as the jury is doing here. It is the same sort of procedure.

Q At the exchange in 1969 who was the competent body that would make adjudications on these charges?

A In the case of a capital violation type of charge it was the Board of Governors of the exchange, which is the same as the board of directors; but they assigned or delegated responsibility for conducting the hearings, for being the jury, in most instances to a committee of the board called the Advisory Committee.

Q Was there any procedure whereby the exchange could avoid all this due process stuff and just put a member firm out of business with just a snap of the finger?

A Yes -- not quite a snap of the finger, but more quickly.

Q Can you tell me what provision that was?

A Well, there is another section of the constitution which provides for a summary procedure to be used in extremely serious cases.

Q Do you know what provision of the constitution that is?

A Yes, that's article 13 of the constitution.

Q What kind of a showing do you have to make to do it like that or maybe just a little slower?

A Well, the language of that section is that the board -- and here the board can't delegate it to a committee -- the board has to find that the firm is in such financial or operating condition that it can't continue in business with safety to its creditors. That means its customers.

Q Has that provision ever been exercised to suspend a member firm?

A Occasionally.

Q Let's turn our attention for a moment - and I am sure it's time we did - to the firm of McDonnell & Company:

In about December of 1968 did you have an awareness of appreciation of the character and quality of the firmof McDonnell & Company as one of the firms

under your charge?

A Yes.

Q Can you tell me what you knew about that firm then just as a matter of your own knowledge and background?

A Well, I had then been in regulatory work for eight years, and in the early stages I traveled around the country a good deal visiting member firms' offices and member firms out of town, and member firms in New York too, but I had visited McDonnell, both their main office and several of their branches in that period, and I was very well impressed with McDonnell. You know, they had the rights business on the exchange, which is very fine professional business; and I was very impressed with them as a retail organization.

I remember in Los Angeles they had co-managers who were running an excellent training program, and at the time I was working a lot on training registered representatives, and I spent a day with them seeing what their training program was about, and they impressed me as very good people, and so did the rest of the people that I met from McDonnell. They were a wide awake, progressive group of people.

Q What did you know about the capital structure? Where did it come from?

MR. BEEBE: Objection. I don't see what the

point is as to where the capital came from or didn't come from in 1968. The question is, the issues that have been hashed out here have to do with what the condition of the company was and what was happening to it.

THE COURT: Is it prejudicial in any way to you?

MR. BEEBE: I believe it may be sir.

THE COURT: Well, do you contend that it is in any way?

MR. BEEBE: I would submit, sir, that it is getting again into areas that are irrelevant and perhaps materially distracting from the major issues at hand, because it is like the Ford and other things that keep coming up which has nothing to do with this case, and are prejudicial.

THE COURT: I will overrule the objection.

A Most of their capital came from the McDonnell family, and what didn't come from the McDonnell family was mostly from other executive officers of the firm and their families.

BY MR. BROCKS:

Q Do you know who controlled the firm?

MR. BEEBE: Objection your Honor. I think that calls for a conclusion of law as well as an operation of someone else's mind as to what is control--

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THE COURT: I sustain it as to form.

Q Did you know who the chief executive officer was of the firm, sir?

A Yes.

Q Who was that?

A Murray McDonnell.

Q Do you know who the chief operations officer of the firm was?

A Thomas McKay.

Q Who had preceded him in that position?

A I don't know who preceded Mr. McKay.

Q Did you know a Sean McDonnell?

A Oh, well, yes, although Sean McDonnell you might call the chief financial officer as opposed to the chief operations officer, and his main work at the time I first met him was in working on their new data processing system.

Q Did you know about the profitability of McDonnell & Company in late 1968?

A They were a profitable firm. The reports they had been submitting to us had shown them to be very profitable for the previous several years, and their profits were growing according to these reports.

Q How many customers did they have in about January of 1969?

A It could have been in the neighborhood of 60,000.

Q How many branch offices?

A 25 or 30.

Q Sir, when someone wants to become a capital contributor to a member firm, such as Mrs. Murphy became in respect to McDonnell & Company, will you tell me what functions the exchange plays in that kind of a transaction?

MR. BEEBE: Objection to the characterization. The question is hypothetical, and there is no testimony that Mrs. Murphy wanted to become what she was asked to become. It is completely a mischaracterization of the situation.

THE COURT: Rephrase it. When someone makes application to become, what happens?

Q When someone makes application to become a subordinated lender, Mr. Bishop, or did make such application in about February of 1969, how would the exchange function on that application? What would they do? What would they consider, and how would it function?

A Providing they are not already a person approved by the exhcnage we would determine whether they were the type of person that was acceptable to be associated with a member firm, and there we would look at whether or not they were a principal of another broker-dealer or a bank. We would

not leta conflict of interest come in of that kind. But providing they were not in those activities, then if they were of good reputation and character and had resources to contribute what they were contributing, that was fine for them as a person.

The second thing we did -- and this was whether or not we had previously approved the person -- was look at the legal instruments by which they were contributing their capital and make sure that it was legally putting it at the risk of the business in a form that was acceptable from our capital rules point of view.

Q Let me show you Exhibit 3 and Receiver's Exhibit B-1, which are the subordinated agreements with Anna McDonnell in 1966 and Margaret Mary Murphy in 1969, and I ask you, was that kind of subordination agreement form generally used at about this time?

A Yes, this is one of the forms that was common.

Let me look at the other one.

This is the same.

Q Now, if the subordinated lender signed one of those and it came in to you, and the exchange were to reject that person because maybe it didn't like the character of the person, would the deal that the contributor made with these firms be a binding deal?

MR. BEEBE: Objection. That calls for a legal conclusion, and I think it depends completely on the instruments involved, and it is hypothetical on top of everything else.

MR. BROOKS: Your Honor, I think Mr. Beebe's point is well taken. I would just like to read a sentence or two from the instruments. That ought to clear the problem up.

MR. BEEBE: Which one are we dealing with?

MR. BROOKS: They are both the same.

MR. BEEBE: I don't know that.

MR. BROOKS: Let's take Receivor's Exhibit B-1. I am reading from paragraph 10.

It says:

"This agreement embodies the entire understanding of the parties hereto and shall be effective as of and from December 30, 1966, whether or not the owner is approved by the exchange."

And I believe Mrs. Murphy's subordination agreement says exactly the same thing in the same paragraph 10.

THE WITNESS: Except for the date.

MR. BROOKS: Except for the date, thank you, sir.

Q Does that accord with your recollection of the customary practices?

A Yes.

Q Now, these agreements provide in paragraph 1A that the owner can give written notice of a hundred days and at the end of the hundred days terminate the agreement.

Would that have permitted the owner to then withdraw the capital that had been contributed at the end of the hundred days?

MR. BEEBE: I would object in the sense that the document speaks for itself. There are a number of other conditions and events that can occur within that hundred days.

THE COURT: I would think that was so; is it not?

MR. BROOKS: I don't think so. I guess we argue on the terms of the agreement.

MR. BEEBE: Well, I just feel that posing to this witness that kind of question, I just feel it is objectionable.

MR. BROOKS: Your Honor, it was his function to supervise these events and approved forms such as these. I believe he does have a background to testify on the question.

THE COURT: Is there going to be something that permits a variation of a written instrument under certain circumstances?

MR. BROOKS: No.

THE COURT: Put another question.

BY MR. BROOKS:

Q When you got a proposed capital contributor such as you would when you got forms like these for your approval, and you got a person to look over and determine whether they are of sufficient character, did you give them any business advice on the wisdom or lack of wisdom in going ahead with the transaction that was put before you?

A No, we usually never saw them.

Q Why didn't you counsel them on business considerations?

A That really wasn't an area of our competence.

Q Did you counsel the member firm on the wisdom of a proposed capital contribution?

A No.

Q Mr. Bishop, I want to go back about a year to early 1968 and ask you whether you recall the arrival at the New York Stock Exchange in and about February, 1968, of a Lybrand audit report for McDonnell & Co. as of October, 1967?

A I don't recall its arrival because I don't think I knew about it until a couple of weeks after it arrived.

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THE COURT: Yes, I will strike it out.

MR. BEEBE: Thank you, sir.

MR. STEIN: I will read it without that.

Q (Reading)

"Q Do you recall in substance what you stated to her?

"A No.

"Q As to subordinating her account?

"A No, except I know that we explained very clearly to her what the risks were and the dangers that were involved.

Do you recall that testimony?

A Yes.

Q Do you now recall what you told her in a bit more detail than a few minutes ago?

A Didn't I say the same thing just now?

Q My recollection is that your recollection wasn't quite as good. We will go on to something else.

A That was a year and a half ago. It fades every year.

THE COURT: Do you gentlemen collectively anticipate more than three or four minutes more?

MR. STEIN: Not for me.

MR. BEEBE: No, your Honor.

Q You testified that you explained very clearly

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to her what the risks were and the dangers that were involved were. Now, do you recall what her reaction was; that is, do you recall whether or not she understood what the risks were?

MR. BEEBE: Objection.

THE COURT: I will sustain the objection in that form.

Did she say anything to you, Mr. Ford?

THE WITNESS: I don't really recall. We were sitting around in her living room and I don't recall who said what to whom. It was a very informal gathering. I don't have any recollection.

Q Did you form the opinion that she understood the risks involved?

MR. BEEBE: Objection.

THE COURT: I will sustain the objection to that.

You told her about the risks?

THE WITNESS: The risks were explained fully.

THE COURT: As you looked at her she appeared to be listening to you?

THE WITNESS: She appeared to be listening.

THE COURT: She conversed with you in this area?

THE WITNESS: Yes.

THE COURT: All right. Next question.

Q Did you know Mrs. McDonnell for any period of time leading up to this meeting?

A I have probably known Mrs. McDonnell for twenty years.

Q Were you able to judge her astuteness about financial affairs based on your having known her?

MR. BEEBE: I object to this line for a number of reasons. Not only the working of this gentleman's mind, which I don't think is relevant, but I think it is getting into the area of what opinions he may or may not have formed as attorney for Mrs. McDonnell. She is not waiving her attorney-client privilege. He as an attorney should not be testifying, I believe, as to what opinions he formed about his own client.

MR. STEIN: The privilege has to do with communications, your Honor.

MR. BEEBE: And the communications that he had with her over the years from which he formed an opinion. It is based directly on his legal services that he performed for her. I don't think he should be put in the position --

THE COURT: Suppose the question were, did he form an opinion as to her financial acumen based on anything that does not invade the attorney-client privilege?

MR. BEEBE: It is completely impossible, your

Honor, to make that kind of --

THE COURT: Let's see if the witness says it is possible or not.

MR. BEEBE: If we could have voir dire on that, because I think he testified earlier that he never met her socially or in any other capacity than as an attorney.

THE COURT: The objection to my question is overruled.

You may answer it.

THE WITNESS: What is the question?

MR. BEEBE: Maybe we could read the question back so it will be in his mind as to the separateness.

MR. STEIN: Could we hear the Court's question which I endorse?

(Court's question read)

THE WITNESS: Read it again.

(Court's question read)

THE WITNESS: I really don't know how to answer that.

Q Let me see if I can put a question. Did you find her to be in any way naive about financial affairs?

MR. BEEBE: Same objection unless it is outside --

THE COURT: Sustained.

Mr. Ford, did you discuss with her matters not

in confidence having to do with finances?

THE WITNESS: I don't think I ever advised her with respect to any financial affairs.

THE COURT: You did not receive confidential communications?

THE WITNESS: No.

THE COURT: Did you get any view as to astuteness in financial matters from the conversations you did have with her on finances?

THE WITNESS: It was my opinion that Mrs. McDonnell was a very astute person that knew exactly what she was doing in all facets of her life.

Q Including the financial area?

A Including the financial area.

Q One further question. Did you consider her a sophisticated investor?

MR. BEEBE: Objection.

THE COURT: Sustained.

MR. STEIN: I have no further questions.

MRS. LICHSTEIN: I have one housekeeping matter, your Honor.

THE COURT: Any further questions of Mr. Ford?

MR. BEEBE: Yes.

THE COURT: Of any length?

MR. BEEBE: No.

THE COURT: All right, go ahead. The housekeeping matter we can take care of after lunch.

MRS. LICHSTEIN: I want to offer Exhibit 94 if Mr. Beebe has no objection.

MR. BEEBE: Are you going to open that whole area up now so we go into all his diary entries?

MRS. LICHSTEIN: I am just offering it.

MR. BEEBE: That opens the door.

THE COURT: Do you object to it?

MR. BEEBE: I think we can cover that on our rebuttal case. If it is coming in at this point I have no serious objection.

THE COURT: It may be received. We will mark it in evidence.

(Plaintiffs' Exhibit 94 received in Evidence)

THE COURT: Go ahead, Mr. Beebe.

RECROSS-EXAMINATION

BY MR. BEEBE:

Q A very quick question, sir. Assuming that Mrs. McDonnell was not informed of the financial condition of the company in 1969, was there any way for her or any other investor to make an informed judgment at to whether or not to subordinate her account?

MRS. LICHSTEIN: I object, your Honor. It is a hypothetical question.

THE COURT: Sustained.

MR. BEEBE: All I ask is that the witness be kept available for our rebuttal case.

THE COURT: Mr.Ford, I am sure if the Court asks you to come back, you will.

THE WITNESS: Yes. I would like to have some notice though, your Honor.

THE COURT: All right.

(Luncheon recess)

AFTERNOON SESSION

2:05 P.M.

(In the courtroom in the presence of the jury.)

MRS. LICHSTEIN: Your Honor, a small problem.

When Mr. Beebe had introduced Plaintiffs' Exhibit 91 for identification I subsequently offered it into evidence, now Mr. Beebe tells me I am wrong, I can't offer into evidence what he has marked as his exhibit.

So if he wants to stick to these formalities, I would like to offer the same exhibit in evidence, and I would offer it as Exhibit JJJ.

MR. BEEBE: No objection.

THE COURT: It can be done either way. If the plaintiff is going to be technical about it, that's it.

(Marked Defendant New York Stock Exchange Exhibit JJJ in evidence.)

MR. BROOKS: We would call as the next witness Richard Olney, III.

R I C H A R D O L N E Y, III, called as a witness, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. BROOKS:

Q Mr. Olney, by whom are you employed?

A I am presently employed by Wood Struthers & Winthrop, 20 Exchange Place, New York.

Q What is the business of Wood Struthers & Winthrop?

A They are a full service brokerage firm. I am employed as an investment adviser in the management subsidiary.

Q Are they a member firm of the New York Stock Exchange?

A They are.

Q Do you appear here today pursuant to subpoena?

A Yes.

Q Did you attend college, sir?

A Idid.

Q Can you tell me what employment you had after college?

A I worked for approximately two and a half years for a firm in Boston known as Townsend, Dabney & Tyson, which was then affiliated with Dominick & Dominick; and in May of 1963 I joined McDonnell & Company in New York.

Q In what capacity did you join the McDonnell Company?

A I went to work in their investment advisory department.

Q Would you trace for me the course of your employment at McDonnell & Company from 1963 up until the employment ceased?

A I worked in the advisroy department essentially since 1968 when I became - I took on the title of Assistant to the Chairman, which recognize that a lot of my activities were related specifically to brokerage accounts administered out of the office of the President or the Chairman.

Q Were you an officer of McDonnell & Company?

A I was.

Q What office did you hold?

A I became an Assistant Vice President at -- I can't recall what time -- and I became a Vice President in January of 1968.

Q Would you tell me what your actual duties were at McDonnell & Company in 1968, what you spent your time on work?

A Primarily there were a large number of what we call family accounts, which were the brokerage accounts that were property of various members of the family. The chairman was trustee on several of these accounts, and it was my job to see that the income was being distributed, the investments were being updated, and changes made as

market conditions warranted it.

Q Would it be fair to describe the services that you rendered as those of an investment counselor?

A With the qualification that much of the work was at times custodial in nature, in that the family investments were in good, high quality listed issues, and there wasn't a great deal of activity in the accounts.

Q When we are talking about family, we are talking about the McDonnell family, are we not?

A Correct.

Q About how many family accounts were there in your charge in and about the end of 1968?

A I would say upwards of a hundred.

Q I take it some of those were trust accounts, some were individual accounts?

A Yes, in size ranging from very small accounts to large individual accounts.

Q In or about that time do you recall whether Anna McDonnell had any accounts which were in your charge?

A She had, to the best of my recollection, I think five accounts.

Q Could you tell me what kind of accounts those five were?

A She had a subordinated securities account; I

believe there was a separate bond account, what we call an income account, and there was a special purposes account, I think it was set up to hold Treasury bills. We call it vacation-trip account.

Q Did she have a margin account, sir?

A I believe that would have been considered one, considered combined, cash and margin.

Q In one account?

A Yes.

Q Did you do any estate planning as part of your duties of working on these family accounts?

A Yes.

Q Did you do any estate planning for Mrs. Anna McDonnell?

A Yes.

Q Can you describe that estate planning?

A Well, upon advice of counsel and accountants it was deemed advisable to make distributions of stock out of her personal holdings to children and grandchildren as part of a long term plan to build up children's accounts and to essentially follow a plan of reducing the individual's taxable estate.

Q To minimize estate taxes?

A Correct.

Q Was that the objective of the plan?

A Yes.

Q And would this process commonly be called the giving of gifts?

A Correct, yes.

MR. BEEBE: Objection to much more of this line as far as relevancy to this case is concerned, your Honor.

THE COURT: Well, let's see where it goes.

Q Did Mrs. Murphy have an account which was in your charge in or about late 1968?

A Yes.

Q How many accounts did she have?

A Personally I think it was captioned margin account.

Q Was that one account or two accounts?

A It is called a composite account.

Q Would you explain to the jury, sir, what the function of a margin account is?

A Well, a margin account would permit the owner of the account to pledge certain securities against a loan which could be then used for the purchase of additional securities for leverage, or to just take money as one might need a collateral loan that one could ordinarily take from a bank secured by stock.

Q Did you do any estate planning for Mrs. Murphy?

A I think only minor.

Q Did you do any investment counseling for Mrs. Murphy?

A We worked with her and her husband pursuing the goals that were agreed by all of us as to the children's accounts, specifically.

Q That would be investment counseling for children, I take it?

A Investment advice for children.

Q Did the children have accounts which were under your charge?

MR. BEEBE: Objection. Relevancy.

THE COURT: Overruled.

A Could you repeat the question?

Q Did Mrs. Murphy's children have accounts at McDonnell & Company which you handled?

A Yes.

Q Sir, do you recall ever counseling Mrs. Murphy on personal investments that she might have made in a venture called Mercury Partners?

A Yes.

Q Can you describe what Mercury Partners was?

A In about 1967 or 1968, one of the methods of aggressively investing was to form what was called a hedge

fund, and it was an investment partnership. People would put in limited amounts of money, and the general partners were usually very experienced aggressive investors, and they managed this pool of capital, and we thought it was it was in the interest of many members of the family, one of whom was Mrs. Murphy, to put a portion of her funds into this vehicle because she could probably expect greater returns than we probably could provide in the more, let's use the word, mundane stocks which we held, which were the big blue chips. These hedge funds were invested in early growth type securities.

Q Did Mrs. Murphy make an investment in Mercury Partners?

A She did.

Q Do you recall how much of an investment?

A I don't recall. I believe it was 150,000.

Q I think that is what you testified to on your deposition. I was trying to refresh your recollection.

Did there come a time in early 1969 when you were asked to play a role in obtaining more capital for McDonnell & Company?

A Yes.

Q Can you tell me what the circumstances that you know of were in respect to that project?

A Well, if I understand you correctly, I was asked to furnish market values and net values of certain accounts which were under my supervision.

Q Who asked you to furnish those values?

A Murray McDonnell.

Q And essentially what did you have to do to perform that task, sir?

A Essentially, make extensions of the price per share times the number of shares held in each account, extend the values, add up the net market value less or plus any credit balance or debit balance and arrive at a net worth for that particular account.

Q Would it be fair to put that in layman's terms by saying you checked the price of the securities and then computed the value of the overall account and came out with a total value?

A You put it very nicely, yes.

Q Whose accounts did you evaluate in that way?

A Well, my recollection is Anna Murray McDonnell, Ann McDonnell Ford, Murray McDonnell, Marjorie F. McDonnell, his wife, Marjorie Murphy, Genevieve Bissell, Jim McDonnell, and Morgan McDonnell possibly. Jim McDonnell, his account may not have been in New York.

Q Now, did you know the purpose of the evaluation that you had been asked to perform?

A Yes.

Q What was the purpose?

A The firm apparently needed to raise additional capital and subordinated accounts were one of the vehicles used to furnish capital and they had to be valued.

Q I take it you did complete the evaluations as you were asked?

A Correct.

Q And came up with the values?

A Correct.

Q What did you do with those valuations when you computed them?

A Turned them over to Murray McDonnell and other members of senior management, Tom McKay, the treasurer of the firm.

Q Did you have any conversations at or about this time with any of those account holders whose accounts you had evaluated?

A Right at the time of the valuation?

Q At or about the time of the evaluation.

A I'm sure I did but I can't recall today what conversations I may have had.

Q Can you recall having a conversation with Mrs. Murphy at about this time?

A As I would the others, yes.

Q How did it come about that you had a conversation

with Mrs. Murphy?

A Well, I believe I was instructed to call her after she had agreed to subordinate her account to explain the mechanics and what the then rate of interest was on a subordinated account.

Q Now, you say after she agreed to subordinate her account. What leads you to say that, sir?

A I believe she was contacted by her brother Murray McDonnell following a meeting at my office. He wanted to know if we were making this evaluation.

Q How do you know about that contact that Murray had?

A Well it may seem difficult to recall all these events, there was a meeting at my office, which is very small, about the size of this area (indicating). It was a very unusual thing for three or four of us to be meeting at my office. But for the purpose of valuing all the accounts I had the files, and I remember Murray McDonnell leaving the office and going back to his personal office to call his sister.

Q Did he speak with you shortly thereafter?

A He returned and he said words to the effect that Margie is in or Margie has agreed to subordinate her account.

Q Did he instruct you to do anything further?

A He said, as he normally would, he said, "You call her this afternoon and explain to her the mechanics."

Q And did you call her?

A To the best of my recollection.

Q And would you tell the jury to the best of your recollection what you said to Mrs. Murphy in that telephone call and what she said to you.

A I recall that I explained to her what the mechanics of subordinating the account were and she had to sign a subordinated agreement and that the firm needed capital.

Q Did you tell her that there was no risk involved in the proposed transaction?

A No.

Q Did you tell her that the New York Stock Exchange or other Stock Exchange seats that the firm owned would stand between her and financial disaster in respect to the transaction?

A I don't think so.

Q Did you tell her that the pictures on the wall at McDonnell & Company would stand between her and financial risk?

A No, because I had no knowledge of that anyway.

Q And I ask you the same question about the furniture in the offices of McDonnell & Company?

A It was leased, to the best of my knowledge. So I didn't tell her that.

Q Mr. Olney, in all your practices as an investment counselor, have you ever told any client that there was no risk in a particular investment?

A I'm sure not.

Q Why not?

A It's the, if you will, underlying nature of our business that it involves risk. I have yet to see the risk-less investment.

Q How about when you discussed the Hedge Fund with Mrs. Murphy? Was there any discussion about risk in respect to that transaction?

A There was a great deal I mentioned of risk, and it was weighed against the potential rewards. I think the record will show that when things did get risky she was permitted a withdrawal of her partnership interest, which I don't think was available automatically under the language of the partnership agreement.

We tried to identify the level of risk that she was taking in going in and the general partners agreed that her circumstance might permit such a withdrawal.

Q Who were the general partners?

A Joel Leff and Anthony Forseman.

Q Was this an opportunity that had been arranged by McDonnell & Co.?

A They were known to certain members of the McDonnell family and they had good reputations and records as money managers, and they approached Murray as a logical spokesman perhaps for finding, let's say, a ready pool of capital, which they did. I think we raised, I think, a million nine among the family to put in this partnership.

Q When you had your discussion with Mrs. Murphy -- perhaps I have overlooked a point, sir. Was this a personal meeting that you had with her when you discussed the subordination transaction?

A No.

Q Over the telephone?

A Right.

Q When you had your telephone discussion with her did you tell her that the subordination was needed for an underwriting?

A No.

Q Did you tell her that she had no chance of losing her money in that telephone discussion?

A No.

Q Did you ever tell that to anybody whom you were counseling in an investment capacity, investment adviser capacity?

A No.

Q Why not?

A I think the rules that we had to follow, the exams we had to take, the general thrust of the training and especially in investment advisory is that there is an element of risk in any investment. This investment in the firm was -- carried risk just the same as an investment in IBM or General Motors.

Q Was it your understanding from the words spoken toyou by Murray McDonnell before you followed his instructions to call Mrs. Murphy that there had been an agreement reached that Mrs. Murphy would subordinate

her account?

A That's the way it was --

MR. BEEBE: Objection. Asked and answered. We are just going over the same testimony for the second or third time.

THE COURT: Let me hear it again, please.

(Question read)

THE COURT: I sustain it. Asked and answered.

Q When you spoke with Mrs. Murphy on the telephone did she say anything to you which indicated to you that she hadn't made up her mind as to whether to subordinate her account?

A Not that I recall.

Q Did you talk to her about the rate of interest that would be paid to her in respect to her subordinated account when you had this telphone call?

A To the best of my recollection that would have been one of the points. I recall discussing the rate of interest.

Q Do you recall what that rate was at that time, sir?

A I am guessing at 6 per cent.

Q Now, would the subordinated account holder in

addition to that 6 per cent continue to receive the normal dividends and distributions on the securities that were subordinated?

A That is correct.

Can I strike the 6 per cent? It doesn't sound right. I don't recall.

Q You don't have a recollection of the interest?

A No. There was an overage paid but I simply don't recall at this time.

Q Do you have a clear recollection of whether the subordinated account holder who would receive the normal dividends and distributions, let's say, on ATT stock thatmight be inthe subordinated account?

A Yes, they did.

Q And they get the interest in addition to that?

A On top of that.

Q Did you discuss that fa ct with Mrs. Murphy, the fact that she would get interest and the dividends and distributions?

A I did, and that was probably more part of my job, in that generating income was one of the objectives of clients.

Q Prior to this time had you had any communication with Mrs. Murphy about difficulties that she was having in keeping her account straight?

A Yes.

Q Would you tell the jury about that?

A Well, what was known as the back office crunch or administrative problems generally in Wall Street at the time, Mrs. Murphy was understandably upset about not receiving dividend income, interest income on time, and we often discussed, in trying to explain to her our frustration and also trying to take care of these income needs and distributions. We were, ourselves, having difficulty trying to --

Q Abouw aht time did youhave this type of conversation with Mrs. Murphy?

A There may have been several. I can't recall at this time.

Q Well, would it be fair to say that it was sometime in 1968?

A I'm sure we had conversations in '68, certainly. We were managing her account.

Q Was this a common problem with all of the customers at McDonnell & Co. at about this time?

A Well, some accounts more than others. And

I told her at times it seemed like we were having more difficulty, at those times. But I was working on some other accounts as well as the family and even though I was right at 120 Broadway where the firm was, to get down to the dividend department I still had difficulty getting them to agree with certain credits and distributions.

Q Doyou recall the evaluation that you came out with when you evaluated Mrs. Murphy's account?

A I don't recall today what the value was.

Q Now, let me try to refresh your recollection. On Plaintiffs' Exhibit 2 in evidence, which is a financial supplement that Mrs. Murphy signed and submitted to the New York Stock Exchange, she stated in paragraph A that:

"I subordinate my claim to the equity in my account with the corporation captioned Margaret M. McDonnell Murphy which has a debit balance of" either 54 or $59,310 "and long securities with a market value of $282,000."

Do those figures refresh your recollection?

A It sounds correct. I would have said 250.

Q Do you recall that Mrs. Murphy did have a debit balance in that account?

A Almost all family accounts were carrying a debit balance, ever since I was at the firm.

Q What does a debit balance mean?

A Well, it permits withdrawals of cash when the need arises rather than, let's say, waiting for a particular dividend to pay on a calendar quarter or an interest payment to come through. It provides flexibility in cash flow.

Q If we were to try to put it in simple terms, does a debit balance reflect a borrowing from the market value of the account?

A It's a loan from the company to the client secured by the securities in that same account.

Q When we say a debit balance that means the client owes the firm that amount of value?

A That's correct. If the account were to be taken out to another house or delivered out to the customer they would first have to pay the debit balance off, either through sale of securities to meet it or provide outside cash.

Q When you say that there is a long securities value in an account, what does that mean,sir?

A It's market value of the securities that are long in the account.

Q If you have a debit balance of approximately $54,000, long securities value of approximately $282,000, what is the value of the account?

MR. BEEBE: Objection. That's not the case here. We have the subordination agreement which shows exactly what the market values of the long securities are.

THE COURT: This is according to the application.

MR. BEEBE: I think that's a misreading of the application and the question is misleading.

MR. BROOKS: It's my exhibit 8, your Honor.

MR. BEEBE: Exhibit 3, which is the signed subordination agreement, would make more sense to use, if I can hand it, as I did to Mr. Brooks, and the last page shows the value. I have no objection to pursuing the question along that line.

THE COURT: This question really asks him to arrive at a net figure as to what line 8 means in toto, does it not?

MR. BROOKS: He said he evaluated the account, your Honor, and I wanted him to try to maek more concrete what he did and to illustrate what he would have come out with, assuming these figures were

tryly representative.

THE COURT: That isn't necessarily the question.

MR. BROOKS: The question was would he subtract the debit balance from the long securities value.

THE COURT: That's what you wind up with as a net figure on your line 8.

MR. BROOKS: I don't think line 8 shows a net figure.

THE COURT: You are asking him what it would be if you put one against the other. For that purpose alone I will permit the question to be answered.

MR. BEEBE: I think it's misleading because it comes up with a net figure that isn't the net figure here.

THE COURT: This is a person knowledgeable in this field and this is a form in this field. The question is what does the form mean?

MR. BROOKS: He is the one that did the actual evaluation.

THE COURT: Ovjection overruled.

Q Let me start again.

A I think I understand you.

Q You think you have the question? Go ahead.

A If you have a market value of $282,000 worth of securities, before you can consider that your net account you must deduct from that value the loan that you have outstanding, which is called a debit balance in brokerage parlance. So you arrive at the client's net account, which is worth 228,000 or something of that nature. The debit balance always has to be deducted from the gross market value to arrive at net equity.

Q How often in and about late '68 and early '69 would you have occasion to speak with Mrs. Anna McDonnell either in person or on the telephone?

A Once a week.

Q Did you assist her with transactions of a financial nature in respect to her holdings and accounts?

A Yes.

Q Did you have occasion to learn whether she kept any records of her own to keep track of these holdings?

A She kept quite good records in terms that she had a ledger, which she turned over to us and her accountant at some point, which I'm guessing at, '68 or

'69, which showed the cost basis of the securities, stock splits.

Q Was that kept in handwriting?

A In her handwriting, that's correct. And dividends received, etc.

Q Now, she had an accountant too, didn't she?

A Excuse me?

Q She had an accountant as well, did she not?

A She had an accountant who prepared her tax returns.

Q Did the accountant assist her with any of these financial notations or calculations that were in the ledger?

A As far as I know he probably reviewed the books to prepare taxes, but she had the information herself.

Q Did you ever review the ledger?

A Yes, when she sent down or made gifts to establish a cost basis.

Q Did you find the ledger to be accurate?

A I can't recall an error.

Q Did you find Mrs. McDonnell to be knowledgeable in conducting her own business affairs?

MR. BEEBE: Objection, your Honor.

THE COURT: Sustained.

Q Mr. Olney, can you recall attending a meeting at the Carlton House Hotel sometime in the summer of 1969?

A Yes.

Q Can you fix the date of that meeting for us?

A It was about July 10th, I believe, because I just moved out to the country.

Q Was it on a weekend?

A Saturday.

Q Who was at the meeting?

A Paul McDonald, Tom Ford, Murray McDonnell, myself, D. Johnson, Ann Johnson, Sandra McDonnell, Mrs. Anna Murray McDonnell. That's my recollection. There may have been more and presumably there were.

Q Could you tell us who Ann Johnson was?

A Ann Johnson was Murrya McDonnell's --

MR. BEEBE: Your Honor, I believe this is not only irrelevant but duplicative on this meeting which we have had testimony about.

THE COURT: Go ahead.

A Murray McDonnell's sister and a subordinated lender and client.

Q She had been married to Henry Ford?

A That is correct.

MR. BEEBE: Objection, your Honor. I move that that be stricken.

MR. BROOKS: I just didn't want any confusion to develop as a result of the change in names.

THE COURT: Overruled.

Next question.

Q Mr. Olney, do you know who Dean Johnson was?

A Yes.

Q What did you know about Dean Johnson at this time?

A I had a few meetings with him. He was a partner in the firm of O'Melveny & Myers of Los Angeles.

Q What was the business of O'Melveny & Meyers?

A Attorneys-at-law.

Q Mr. Olney, these numerous McDonnell family accounts which you testified with respect to, did the firm of McDonnell & Company levy any charge for the services that were rendered with respect to these accounts?

A No.

Q I want you to focus onthe telephone conversation had with Mrs. Murphy in the beginning of 1969, what you told her in that conversation, what she said to you, and

I am going to ask you if at any time after that conversation Mrs. Murphy told you she thought you had not told her the truth in that conversation?

A I don't recall.

Q That is something you would recall, isn't it?

A I believe so. It is a long time ago.

Q Do you have any recollection of her making a complaint to you about anything in that telephone conversation?

A No.

MR. BROOKS: I have no further questions.

MR. BEEBE: May I have that exhibit I handed you, please?

MR. BROOKS: Yes (handing).

CROSS EXAMINATION

BY MR. BEEBE:

Q Sir, you were examined as to Exhibit 2, particularly line 8, various debit balances and credit balances there. I show you Exhibit 3 in evidence. Would you direct your attention to the last page which is headed Margaret M. McDonnell Murphy's subordinated account, and it shows a total market value of $342,433.

I ask you, sir, if you deduct from that market value $342,433 the debit balance of $58,810, as indicated

in Exhibit 2, don't you get exactly the market value shown on Exhibit 2 of $283,623, to the penny?

MR. BROOKS: I object.

THE COURT: The objection is sustained.

The next question is what does he know about that, if anything. Mathematically that is established without the intervention of the witness. Now what is the next question.

BY MR. BEEBE:

Q Do you know, sir, does that refresh your recollection as to what the exact net market value of her securities in her accounts was at that time?

A No, but I can add something which may have to be factored in here. There is an account number up in the left hand which has that single digit 6 after it. That was the code for subordinated account. I believe the debit balance would have been carried in code number 2, and I think that all accounts would have been netted. I really can't take this isolated document and determine what your values were.

Q So you cannot testify here even after being refreshed by these various documents as to what the value of her account was?

A I think the brokerage statements would -- the

actual brokerage statements would provide the answer.

I haven't seen this before so I don't think I can nine years later or five years later --

Q I asked you simply if it refreshed your recollection, and I take it it is not refreshed.

A It is incomplete.

Q Your recollection, sir.

A No, this particular valuation. This is a typed schedule and is not proof, at least to my familiarity with this kind of stuff.

Q As you sit here today can you tell us as you did this valuation of these accounts what the bottom line was as far as Mrs. Murphy's account?

A I can't recall now, six years later.

Q Now, sir, when you had this meeting in your little office that you testified to with Murray McDonnell, you said there were other people there. Who else was there?

A Tom Ford, and my assistant, a fellow named Keith Burden.

Q Do you remember whether this meeting was held on January 29, 1969?

A I couldn't possibly recall.

Q Did Mr. Murray McDonnell simply walk into your room with the others and commence the meeting? Is that how it started?

A Yes. As I say, it was unusual for him to come to my office. It was usually the other way around.

Q And what did he say when he came? What did he say the subject of the meeting was?

A He said "We have got to raise some capital, and what are the values of the following accounts; or, you know, where can we look to raise some capital?"

Q What did he say why, if anything, the capital had to be raised?

A I don't think he elaborated. He didn't have to.

Q You knew?

A I wasn't challenging his question to provide him with some values.

Q Did you know what the need was for the raising of capital at that point?

A When you say "need" --

Q You said you had to raise some capital. Did you know why you had to raise some capital?

A I wish you could be more specific. "Need" is vague

Q Did you have any knowledge at that point as to what the need was for the capital?

A Only that the firm was presumably on an effort to raise additional capital.

Q And what was the purpose for raising it, sir?

A The purpose wasn't in my bailiwick. It could have been for a variety of reasons.

Q Did anyone tell you in that period, in 1969, what the purpose was?

A The firm was obviously having some problems common to the street. The raising of capital was not an infrequent activity, if you will.

Q And what were the problems that the firm was having?

A I would characterize that as those germane to the whole industry at the time.

Q Specifically sir.

A I cited that we had trouble getting Mrs. Murphy's dividend out.

Q The records were problematical? Was that one of the problems?

A You put the words in my mouth--

MR. BROOKS: I object to that. I don't know what it means.

THE COURT: Sustained.

Q What were the problems that McDonnell was having

at that time, sir?

A I characterized one that I was involved primarily in the handling of accounts, and the nature of the problems of the 23 branch offices were not really in my area of responsibility.

Q I am asking you what you knew. Was the one you characterized one with dividends?

A This was a personal problem that I became associated with because I was investment manager. I was like the interface between the client and the firm.

Q And what was the dividend problem that you personally had encountered?

A Inability to perhaps credit the account with the proper amount of dividends. Maybe there had been a stock split, and maybe only a hundred shares out of a 200-share position were credited.

Q Was this in the 1968 time frame that this was occurring?

A I can't give you the dates. I think you would have to refer to what the Journal reported as that time frame.

Q What Journal?

A The Wall Street Journal had at that time articles as to the conditions in Wall Street, and I

wouldn't want to give you a specific date.

Q Was it prior to this time that Mr. Murray McDonnell came into your office?

A We had problems up to then.

Q What other problems, if any, were you aware of in the company prior to that time?

A I think it is a very broad question.

Q Yes, sir.

A I was aware of problems in keeping good people; problems associated with new branch offices; problems with the Telephone Company. I mean, I can't identify what I think you are trying to draw out. I can't single out what specific function within the firm.

Q Were there any capital problems?

A Well, when somebody comes to me and says they are raising capital I can only assume. I wasn't in charge of that. I never was involved in the calculation, let's say. That would have been Tom McKay's offices.

Q The calculation of what, sir?

A Of the firm's capital.

Q You were Mr. Murray McDonnell's -- you were assistant to the chairman, were you not, in 1968, you testified?

A That's correct.

Q And the chairman was Murray McDonnell, was he not?

A Correct.

Q During the course of your tenure in 1968 when you became assistant chairman, did he ever discuss with you or in your presence, or did you ever attend any meetings where problems of the company came up? Does any of it stick in your mind?

A Let me identify my role. I was assistant to the chairman, and I had a great deal of personal liaison, if you will. I had no line responsibility or authority in the firm, and I had limitations, and I kept my distance, and I considered myself in the clients' corner. I was representing Anna McDonnell, Margaret Murphy as an investor, and they were subordinated lenders, but my concern was with their investment and the performance.

Q We will get to that in a minute. My question at the moment is directed to your involvement, what you learned in 1968, if anything, however you learned it, by attending meetings, by Mr. McDonnell telling you, whatever your knowledge in your head was in 1968 about the problems in your company.

Do you remember attending any meetings where this was the subject of discussion?

A No, I didn't attend those kind of meetings because

I was not in the mainstream of the company's activities.

Q Did you know from your working with Mr. McKay or others who were there at the time that such meetings were held?

MR. BROOKS: I object.

THE COURT: Sustained.

Q Do you know from whatever source what problems, if any, McDonnell & Company was encountering in 1968?

A You hear a lot both from people up top to the margin clerks. The reliability has got to be highly questionable.

Q Sir, as a former vice president of the company I am asking you what did you hear in 1968 about problems at McDonnell & Company?

MR. BROOKS: I object to the question. It just calls for a rumor that he didn't credit. If he wants to know what the man's knowledge is, I think he should ask him.

MR. BEEBE: I think, your Honor --

THE COURT: Even more than that, isn't this beyond the scope of the direct examination of this witness?

MR. BROOKS: I believe it is. I asked him nothing about --

THE COURT: It should be either on the case in

chief or in rebuttal, if it is relevant.

Sustained.

MR. BEEBE: On that ground I will wait for rebuttal

BY MR. BEEBE:

Q Sir, we had marked this morning during the course of Mr. Tom Ford's questioning, and he testified a little about Exhibit 94 which I believe came in as Exhibit JJJ.

It says on January 29th: "Conference at McDonnell & Co. re 325 capital requirements."

You said that Tom Ford was at this meeting in your little office. Did the subject of 326 capital requirements come up at that meeting?

A We are assuming -- I didn't say that was the January 29th meeting. Tom Ford came over a lot.

Q I am asking you, at that meeting, the one that Mr. Ford had in your little office, will you tell us was the subject of 325 capital requirements mentioned?

A They came over to discuss raising the capital, and our meeting was restricted primarily -- there are two things that I recall. Number 1, the valuations. Number 2, we discussed at great length the risk of, you know, putting his sister Genevieve Bissell who had her money in a trust, and a lot of the discussions centered around that, and

we arrived at the conclusion that that account should not be subordinated; it was a trust and it was improper.

So we spent more time on the client interest rather than the stock exchange--

Q We will get back to Genevieve in a moment, but my question directly, sir, is, was the subject of 325 capital requirements mentioned by Tom Ford or anyone at that meeting?

A We were doing calculations. I don't think we discussed Rule 325. It would have been discussed in the treasurer's office, not my office.

Q In other words, it was not discussed in your office; is that your answer?

A I can't recall exactly what took place six years ago or seven years ago at a specific meeting. The thrust of it was on the investment.

Q There was no need for capital for underwriting at that point, was there, sir?

A I don't think so, but, again, I had no knowledge of what underwriting was doing at the time.

To go further, I don't think we were doing any underwriting at the time.

Q Now, at that meeting in your little office when you were discussing the valuations of the different accounts,

did you discuss the question of whether or not to approach different people to subordinate their accounts? Did anyone at the meeting discuss that?

A I think Murray did.

Q Excuse me?

A It was his family, and it was up to him. Some of them were subordinated lenders already.

Q Was the subject of whether or not to approach each of the people kind of ticked off on a checklist? Is that how you handled the meeting?

A It was more informal than that.

Q Are you acquainted with Barbara Hennessy?

A Yes.

Q Or were you at that time?

A Yes.

Q Who was Barbara Hennessy?

A She was assistant to Murray McDonnell.

Q And what was her husband's position at that time, John Hennessy?

A He was president, I believe, of Siska & Hennessy. That is an engineering firm in midtown.

Q Was she approached?

A I don't believe so, and I don't want to get into maybe the reasons why, but I think -- she may have been

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I don't know.

Q But you didn't know of her being approached as a result of that meeting?

A No.

Q Mary Murnane.

Do you know who she was?

MR. BROOKS: Your Honor, I object. I think this is beyond the scope of the direct.

THE COURT: Yes, where does this go, Mr. Beebe?

MR. BEEBE: This goes exactly as to why they approached some and not others, and it's exactly on the scope of the direct. He testified that they had this meeting and decided whom to approach, and it is very germane as to the question of why certain people were or were not approached.

THE COURT: On what aspect of the direct examination is the cross examination?

MR. BEEBE: The very subject of raising funds as a result of that meeting, and Mr. Murray McDonnell coming in and asking to have funds raised, and the doing of an evaluation of all the accounts --

THE COURT: The direct was limited to what happened at that meeting.

MR. BEEBE: And his valuations.

THE COURT: And his valuations.

MR. BEEBE: Of all the accounts.

THE COURT: Whether people were solicited or not solicited as a result of that meeting was not the subject of direct testimony.

MR. BEEBE: Well, that, your Honor, I would say-- I would have to then recall this man in rebuttal, because if it is that narrowly construed - I don't remember a precise question along those lines, but the subject was certainly raised, the subject of his doing a valuation of all the family accounts.

MR. BROOKS: He didn't say all, your Honor. He said three or four, I believe.

MR. BEEBE: He named them, and the question is why didn't they do the others?

THE COURT: Well, in the interest of time I will overrule the objection.

Go ahead.

Q Who was Mary Murnane, sir?

A She was a sister of Murray McDonnell's.

Q Do you know whether she was approached?

A Her account wasn't at the firm. Her husband was in another brokerage firm which took care of her account.

Q Was she approached to subordinate funds or lend

funds to the company?

A I don't know, but I doubt it.

Q Sheila Cooley: was she another sister?

A Correct.

Q And was she approached to lend funds to the company?

A I don't know. I doubt it.

Q Her husband at that time - was he the president of Wells Fargo Bank?

A I think so.

Q You mentioned Genevieve Bissell. Was Genevieve Bissell a retarded sister?

A I never met her and I don't think I should answer that question. I don't know.

Q Do you know that when dealing with her account you were dealing with trustees?

A Yes.

Q Was Jim McDonnell one of the trustees?

A I believe so, yes.

Q Do you know whether or not Genevieve Bissell or her trustees had previously taken a position on subordinating funds to McDonnell & Company?

A The subject was discussed because of the amount of extra income which would have been helpful to the benefici-

Q Was it discussed in terms of trying to convince the trustees to subordinate?

A They determined it on their onw that it wasn't going to be done.

Q Who was Charlotte Harris at that point?

A Another sister.

MR. BROOKS: I object.

THE COURT: How many more?

MR. BROOKS: 14, your Honor.

MR. BEEBE: That's the point, that's exactly the point.

MR. BROOKS: I see no purpose in this.

THE COURT: This goes way beyond the scope of direct. If you want to do it I will let you do it.

MR. BEEBE: I will do it as quickly as possible.

Q Charlotte Harris, sir?

A Another sister.

Q She was not approached?

A Account not at McDonnell & Company.

Q She was not approached, I take it.

A I don't think so.

Q Her husband was a vice president of a major shipping company at that point, was he not?

A He was at one time. Whether he was then I don't know.

Q Catherine Sullivan is another sister who wasn't approached?

A Correct.

Q Do you know why she wasn't approached?

A I don't think they were close.

Q There is another brother who is known as Bishie McDonnell?

A Right.

Q And his first name is Charles; is that right?

A That is right.

Q He also was not approached; right?

A I don't know. He was at another firm and there would have been a prohibition against putting money in, I think.

Q He left McDonnell & Company under some tension with Murray McDonnell previously?

MR. BROOKS: Your Honor, where are we now?

THE COURT: Sustained.

Q Was James McDonnell approached at one point? He is one of the parties sitting here.

A He may have been. I don't recall. I think he probably was.

Q At that time he was approached to lend money?

A I'm sure he was.

Q Why are you sure he was?

A Because he was working for the firm and was a stockholder and would have had an interest.

Q Sir, if I could refresh your recollection from testimony here that he did not -- and exhibits that he did not become a stockholder until April or May of that year.

A Okay. I didn't know everything about the company. Especially today I can't recall it all.

Q You don't know whether he was approached or not, do you?

A That's correct.

Q You mentioned Ann Johnson, I believe was her name. I take it she also was not approached at that point?

A Excuse me?

Q She also was not approached at that point?

A She was already a lender.

Q She was not approached to put more money in, was she?

A That's not quite true.

Q Well, do you know of your own knowledge

what was done as a result of that meeting that you had in your office?

A There was an agreement. I don't know the timing, but she converted some securities to treasury bills which provided a higher lendable value.

Q Do you know if she was approached --

A Which was in effect like putting in more money.

Q Do you know if she was approached to add any securities or any new funds to her subordination at that point?

A Well, I explained to you just what took place.

Q Apart from what you just said?

A I don't know.

Q There are only two more and I will lump them together. Morgan McDonnell and Gerald McDonnell, two other brothers.

A Morgan McDonnell was already a subordinated lender.

Q Was he approached to put in more funds?

A These would have been directly with him so I wouldn't know.

Q And Gerald McDonnell, do you know if he was

approached?

A I strongly doubt it.

Q You were asked on direct about whether you had any later conversations with Marjorie McDonnell -- Margaret Murphy and there has been testimony that Mrs. Murphy tried to reach you by telephone during the summer of 1969.

Do you have any recollection as to receiving phone calls from Mrs. Murphy during that time?

A I received phone calls from Mrs. Murphy and from many other members of the family.

Q During the summer of 1969?

A Sure, as I always did.

Q And did Mrs. Murphy askyou at one point to arrange a contribution from her funds, her account to a charitable institution in New Jersey; do you recall that?

A Her account being one of hundreds, she may have been. There were contributions from time to time from the family accounts. If she said she did I'm sure she did.

Q And it's your experience that Mrs. Murphy is a truthful person, is it not?

A It was not unusual to make gifts of securities

out of people brokerage accounts to meet charitable obligations.

Q Let me ask you this, sir: Did you tell her after she had made this request that she could not make a contribution from her account because it was subordinated; do you recall that?

A I don't recall that.

Q Would it have been possible to take funds out of a subordinated account and contribute them to charity?

A If the account was, I think, above a stated subordinated value withdrawals were permitted, I assume, with stock exchange approval. This is my vague knowledge or recollection of the rules.

Q If it were below the subordinated value or the stock exchange did not approve it could not be withdrawn; is that your recollection?

A That is my understanding.

Q Did there come a time in 1968 when McDonnell & Company started to have operating losses?

MR. BROOKS: Your Honor, this has nothing to do with direct testimony.

THE COURT: Sustained.

MR. BROOKS: It's beyond his testified

competence.

MR. BEEBE: I don't know about the competence. As an officer of the company I think --

THE COURT: It's beyond the scope of direct.

Q You testified that Mrs. Murphy was permitted to withdraw from the Mercury partners, I think you said. There came a point when she was permitted to withdraw her account there?

A That's my recollection. I'm not stating it as a hard fact, but I believe she was permitted to make a withdrawal earlier than the terms permitted.

Q Doyou recall if she was permitted to withdraw her subordinated account from McDonnell & Company?

A I don't think so.

Q You remember that she asked to withdraw her account from McDonnell & Company?

A I don't recall.

Q You testified as to advisory accounts. Mrs. Murphy's account was a non-discretionary account: is that correct?

A I believe so.

Q And it was not an advisory account; is that right?

A There was no fee or contract on record.

Q This was not an account that was traded, was it?

A No, by virtue of the good quality securities that were in there and low tax basis, low cost.

Q You mentioned she put in $150,000 in the Mercury Partners. Wasn't the minimum investment supposed to be $200,000?

A It was.

Q Did the other investors put in 200,000?

A We had some exceptions, in a desire to get the fund going.

Q She was one of the exceptions?

A She was one of the exceptions.

Q Was Mrs. Anna McDonnell's account also one of those accounts with low tax base securities so that they were not actively traded?

A Mrs. Anna Murphy McDonnell?

Q Yes..

A Yes, that's correct.

Q Did you call Mrs. Anna Murray McDonnell in late January 1969 in connection with adding funds to her subordinated account?

A I think it was all done by her son, Murray McDonnell. I could have called her about the mechanics

or the transfer.

Q But you don't remember doing so?

A No. But we would have been involved in instructing the margin department to journal securities from one account to another.

Q You told us everything you told Mrs. Murphy in that January conversation, have you not?

MR. BROOKS: I object to it being characterized as a January conversation. Mr. Olney has been unable to date it.

THE COURT: I sustain the objection to the form of the question.

Q Did Mrs. Murphy ask you any questions in that conversation?

A I'm sure she did.

Q What questions did she ask you , sir?

A I'm sure she asked about how the rate of interest was paid. I mean this was one of the reasons for her subordinating. It was advantageous to provide additional income.

Q Did she ask you any questions about the risk?

A She may have. I think she probably did.

Q What did you tell her?

A I'm sure I explained what limited knowledge

I had of the risk of an investment in a family company of which her brothers and sisters were also -- and her mother had put money in. I couldn't articulate the risks in terms of rules and regulations.

Q Did you mention anything to her about various assets that the company had?

A No.

Q Do you remember mentioning to her anything about furniture?

A No. And furniture isn't an asset, so I didn't tell her about furniture.

Q Is furniture part of the net worth of the company?

A I don't think so because it was leased by something called McD Leasing. And the paintings were, as you brought up before, in some cases owned by individuals, not the firm.

Q Did you tell her anything about the problems of the company when she asked you about the risks?

A You have a pretty long conversation going here.

Q Was it a long or short conversation?

A I think it was pretty short. She was familiar with the problems as we were both trying to

work them out.

Q But you didn't tell her anything, add anything to her information about the problems, did you, sir?

A I can't recall the whole nature of the conversation.

MR. BEEBE: No further questions on cross.

REDIRECT EXAMINATION

BY MR. BROOKS:

Q You testified that you evaluated Anna McDonnell's account, I believe. Did Anna McDonnell put in any more capital to that account at this time?

A Yes.

Q Was that account subordinated at the time you evaluated it?

A She had a subordinated account.

Q Did she add more assets to that account?

A I think she agreed to subordinate more securities which were put into that account already in existence.

Q Did Anna McDonnell's addition to her already subordinated account precede Mrs. Murphy's subordination?

A I think so becasue she had a subordinated account already opened.

Q How about Marjorie F. McDonnell, Murray's wife, did she add to a subordinated account?

MR. BEEBE: It's beyond the scope of the cross. That's my objection.

MR. BROOKS: I think he has got me, your Honor.

THE COURT: Sustained.

MR. BROOKS: No further questions.

THE COURT: We will take our recess now.

(Witness excused)

(Recess)

(In open court; jury present)

MR. BROOKS: We call as our next witness Mr. Paul McDonald, with a D.

P A U L K. M C D O N A L D, called as a witness by the defendant New York Stock Exchange, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. BROOKS:

Q By whom are you employed, Mr. McDonald?

A W. R. Grace & Company.

Q What is your position there?

A I'm vice president.

Q Have you attended college, sir?

A Yes, sir.

Q What college?

A Harvard College.

Q Did you graduate with a degree, sir?

A Yes, sir.

Q Did you have any training beyond college?

A Law school.

Q Which law school?

A Harvard Law School.

Q Did you obtain a degree?

A Yes, sir.

Q Are you admitted to the bar in any state?

A Yes, sir, Massachusetts.

Q Summarize for me your employment since you graduated law school up until July 1969.

A I was at W. R. Grace & Company for nine years and then I had my own small investment company for nine years, which I still have. Then I returned to W. R. Grace & Company in May of 1974, a year ago.

Q Did you see any service at McDonnell & Company, Incorporated?

A Yes, sir.

Q Would you date that period of that service?

A Between July 1, 1969 and approximately March 17 of 1970, eight months.

Q And in what capacity did you serve at McDonnell & Com pany?

A I had a series of capacities. I became involved first when I was requested to invest some money in the company in the last quarter of 1968. Then in the second quarter of 1969 I was asked to interest myself in the company as a problem and as a friend and as a consultant, which I did. And in the ensuing months I became president and chief executive officer and sole

trustee of the voting trust representing the controlling ownership.

Q Let's back up just a bit to the consulting firm that you had prior to joining McDonnell. Could you describe the service that that firm would provide for a client or a customer?

A Yes. Well, it was a two-pronged service. It was by and large helping organizations in the public domain, hospitals, child care institutions, colleges and others with their financial problems and at the same time managing their portfolios and those of a few families.

Q You mentioned that in late 1968 you had been asked to put money into McDonnell & Co. Was it your money that you were asked to put in or was it clients' monies that you were asked to recommend investment in McDonnell & Company?

A There was no preference stated as to where the $8 million would come from. But the thought was I would be able to marshal some funds from other sources not necessarily my clients.

Q And did you decide to make the attempt?

A I studied the case and decided not to make the attempt.

Q What was the basis for your decision not to make the attempt?

A Well, there were two or three considerations. One was I had the meetings with the management of McDonnell & Company and I looked at financial statements and their cash flow projection and it seemed to me, who at the moment was very nervous about the future of Wall Street, that it represented a higher risk than I cared to take.

I also studied the subordinated lender agreement under which funds would be contributed to the company and concluded thatthis was an agreement which I would not enter.

Q What did you know about Wall Street at that time which led you to believe that it didn't have a good future for such an investment?

A Well, I had been investing money in, let's see, the end of 1968. I had taken all of my funds out of the common stock market then because, a self serving statement, I foresaw a bad time for the common stock market. I knew this would have implications upon the volume and the revenues that stock brokerage houses could earn.

Q You said you were approached a little later on

when you joined up with McDonnell, as a friend. Did you know personally any members of the McDonnell family say in early '69 or before?

A Yes. It was primarily Murray McDonnell who was the chief executive officer of McDonnell & Company, yes.

Q That you knew on a personal basis?

A Yes.

Q Did you know Anna McDonnell?

A Yes, sir.

Q Did you know James McDonnell?

A I don't think so. I may have met him socially. I don't recall it.

Q Did you know any other members of the McDonnell family before you came aboard at McDonnell & Co.?

A If I did, I don't remember them.

Q You said that you were asked to come aboard as a consultant in the initial stage; is that correct?

A Yes, sir.

Q Can you tell me who approached you to come in as a consultant and what that person said to you and what you said to him?

A Well, in the first instance it was Murray

McDonnell who asked me to come in. He knew I had had experience with companies and managment, principally by virtue of my time at Grace, and he continually expressed the thought that he had planning problems and management problems and capital problems, and I repeatedly said that I wouldn't even consider it unless all of the management asked me to come in. I knew that he had brought in a fairly expensive president only a few months before and that it would be quixotic to try to do anything unless they all wanted somebody to come in and do something.

Q About what time did you have this conversation with Murray McDonnell?

A There were several conversations and I would say they ran during April, May and June of 1969.

Q Would Lawrence O'Brien have been the expensive president that had been brought in a few months before?

A Yes, sir.

Q Was there a subsequent conversation with Murray McDonnell about your coming aboard McDonnell & Company's management team?

A Could you narrow that down a little bit?

Q Well, you have told us of the one conversation where he put the proposition to you and you

told him that you wouldn't consider it unless all management was agreed.

A Right.

Q What happened next?

A Well, that was not once, that was several times.

Q I see.

A I think the next key moment, which I think you are after there, was a moment in middle or late June of 1969, when I was in my office at maybe 20 minutes of ten one morning and Murray asked me to come right over, that negotiations were starting at 10 o'clock that morning for a merger of the firm with a company called Scheinman, Hochstein & Trotta and that all of the management of McDonnell & Company had coalesced in the decision that they wanted somebody else to come in and negotiate with Scheinman on behalf of McDonnell. And so I went over and had a training period of about ten minutes and began the meeting.

Q Did that rather short notice assignment generate into a more permanent position at McDonnell & Company?

A Yes, sir.

Q Can you tell me how that came about? Were

there any formal arrangements, a contract or discussions to formalize your position there?

A Well, frankly, I backed into it. It was a case of increased distress, if I may. And the management of McDonnell & Company at the moment had their disagreements among themselves. As I talked to Scheinman, Hochstein & Trotta I realized that the situation was rather serious, that a merger was not going to be the easy answer, and I began, I guess, developing into more and more responsibility. Ultimately there was a formal relationship. I think I said in the deposition it was a matter of levitation into a vacuum.

Q Had you gotten yourself solidly into the vacuum by the end of June, say, 1969?

A No. Not solidly. I would say in July and August I became frialy solidly involved to a point where I didn't feel I could walk out.

Q Do you recall a meeting at the Carlton House Hotel about late June or early July, 1969, sir?

A Yes, sir.

Q Who called that meeting?

A Murray McDonnell and I called that meeting.

Q What was the purpose of your calling that meeting?

A Well, the purpose was to put the investors in the company, particularly the family, on notice that the situation was very serious.

I think that Murray and I spoke of it to each other in terms of giving them a "straight dosage," particularly Mrs. Anna Murray McDonnell, as to whom everybody is very respectful, and warn her more or less that in terms of their life style they should stop thinking of McDonnell & Company as being a significant source of income.

Q Do you recall how long the meeting lasted?

A Oh, my goodness, it seemed forever. I would guess maybe an hour and a half.

Q Were you the fellow at the meeting who gave them the "straight dosage"?

A Primarily, yes, sir.

Q Did you then talk for approximately an hour and a half?

A That is a guess. More or less, yes, sir.

Q And was the subject matter of your conversation the problems at McDonnell & Company?

A Yes.

Q What did you tell them? What problems did you discuss?

A Well, it was fairly early in the game. I think that we told them -- I am trying to think a minute now -- I think that we told them -- the primary purpose of the conversation was to warn them that their capital at risk was terribly at risk and that if circumstances in the investment banking industry could improve, fine; but if they didn't they may lose their money.

Q Can you recall the group that attended that meeting, the names of the individuals?

A Well, I remember some of them clearly, of course. Murray and I were there --

MR. BEEBE: Excuse me, I believe this is doubly or triply redundant. A question on this subject has been asked and answered many times. It is getting very duplicative.

THE COURT: Well, can you recite them quickly?

THE WITNESS: The persons?

THE COURT: Yes.

THE WITNESS: Murray and I, of course, went together; Mrs. Anna Murray McDonnell was there; Anne Johnson and

Dean Johnson; Sandra, Morgan McDonnell, and there were others I didn't know them at the time so I don't register a clear image of that.

Q Did you have any personal conversation at this meeting with Anne Murray McDonnell?

A Oh, I don't recall anything other than the courtesies.

Q Thereafter, let's say between the Carlton House meeting and the end of the summer, which I would place arbitrarily at Labor Day, did you have any occasion to talk with Anna Murray McDonnell either on the phone or in person?

A I couldn't say absolutely yes or no. It is entirely possible I did.

Can you narrow that down or help me at all?

Q Let me try.

At your deposition, pages 63 and 64, beginning at the bottom of 63, you testified:

"First as to information, the investors were kept very well informed. I can certainly testify to that because I assumed that responsibility myself and I spent an awful lot of time talking about it.

"Q (By Mr. Dubin) Let's talk about our clients. In this instance you were talking about Anna McDonnell.

Will you tell me how you related the information to her?

A Yes. There were some occasions when I called her up to talk to her, and whenever I did she always responded by saying whatever was all right with Jim was all right with her, and in some cases whatever was all right with Murray it was all right with her, and in some instances whatever is all right with you" -- I take it you -- "is all right with her. She is a very lovely lady."

Does that refresh your recollection?

A Yes, that is true. I wouldn't necessarily box it into Labor Day though, counsel.

Q It would continue beyond Labor Day?

A Yes.

Q Would it have taken place before Labor Day?

A Probably.

Q And in these telephone conversations would you discuss the affairs of the McDonnell Company with Anna McDonnell?

A Well, I would try, but, honestly, I think -- well, she appeared to me not to want to hear too much of it.

Q Did you form a judgment as to why she didn't want to hear too much of it?

A No, but, you know, she is a beautiful person, and she was an elderly lady even then, and I sensed that

it was a discomfort to her.

Q At the Carlton House meeting did you discuss with the investors any plan or way of attempting to work out the problems that McDonnell found itself in?

A Well, I am sure we did in general terms indicate a determination to try to salvage the firm.

I am also sure that we were not able to give them a very specific plan because this was an incident without precedent at the time, and we did not really know what our options were. We were simply determined to discover them and to analyze them and to do what we could.

Q What did you mean when you said this was an occasion which was without precedent at the time?

A Well, repeatedly as we went through this event, counsel, where we came upon questions, decisions, and we sought to find out what the rules of the game were, and repeatedly we were told that there really hadn't been an insolvency or a threatened bankruptcy of a major member firm of the New York Stock Exchange in recent times. There had been Ira Haupt, which was a clear case of wrongdoing, which was really not a precedent, and so we were constantly required to do what we thought was right.

Q Did you during this period of the summer of 1969 make any analysis of the alternative of closing McDonnell do

A Yes, sir.

Q And what was the conclusion you reached as a result of that analysis?

A I particularly formed a little informal group of prominent people in the investment banking industry who were concerned with the industry and with the implications of this incident for the industry, many of them much older men, and I went around to see them and asked them their advice, particularly upon the possibility of liquidating the firm quickly in the interest of saving what capital was there.

The advice I received and the conclusion which I reached was that that was the one thing we should not do. The reason, if you want to know, I will tell you.

Q I would like to know.

A Well, there had been particularly a problem in the back office when McDonnell & Company had undertaken to convert their operations to a computer, and I recall learning early in the game that in November of 1968 there had been a time span of some 10 business days when the computer had simply elaxed blank tape. There was nothing but blank tape came out of this machine, and again I understand it happened in May of 1969.

In those days they were doing something like 65,000

trades a day or a week, so there was a tremendous block of business as to which there was no record, and nobody knew what the transactions were or what the liabilities might be, and it was this question of the contingent liabilities that caused a great many of the subsequent decisions.

Q Did you come to any conclusion as to what would happen to the investments of the capital contributors if McDonnell & Company liquidated at about the time you made this analysis, I guess in midsummer of 1969?

A Yes, sir.

We were unable to identify whether those contingent liabilities were $20,000,000 or $200,000,000, but we were reasonably sure, based on the volume of business done, that the contingent liabilities were well in excess of the capital available in the firm, and we concluded that the liquidation of the firm was one quite certain way to eliminate all of the capital in the company.

Q And I suppose the other alternative presented some hope of continuing and saving some?

A Just some hope, yes, sir.

Q Let me show you a memo to which is attached a press release which was admitted into evidence as Exhibit T, Mr. McDonald, and I ask you if that is familiar to you?

A Yes. You recognize it as being six years, and, you know, if you tried to fool me you probably could, but in substance I recognize this, and this was a statement that was issued on August 1, 1969.

Q What about the memo, the first couple of pages, sir? Can you tell us what that is?

A Well, it was a statement to all officers and stockholders of McDonnell & Company from the management task force reporting the action plan that was being adopted effective August 1st to attempt to salvage the firm. It involved an announcement of a rather severe expense reduction including salaries and a reduction in work force and some changes in personnel.

Q Let's focus on the press release, sir.

That reports on an arrangement that had been reached at the time for an infusion of I believe it is three to ten million dollars in capital. Were you familiar with that arrangement?

A Yes.

Q Had such an arrangement been reached at the time the press release was put out?

A Yes.

Q Can you tell me with whom the arrangement was reached

A The arrangement was reached between myself and

Dan Lufkin.

Q Could you identify Mr. Lufkin for the jury?

A Mr. Lufkin was one of the founders and, I believe, chairman of the board of Donaldson, Lufkin & Jenrette, a member firm, and at the time was a member of the Board of Governors of the New York Stock Exchange.

Q Was he personally going to put money into McDonnell?

A Yes, if permitted.

Q What was the problem? Why was permission necessary?

A There was a constraint, I don't know whether it was a constraint by the SEC or the New York Stock Exchange, but there was a legal type constraint against a principal in one member firm investing in another member firm, and he contemplated obtaining an exception because of the exception circumstances.

Q Was Mr. Lufkin also marshaling other people's money to make this capital infusion?

A Yes, sir.

Q Now, I take it on the day of the press release you considered you had a deal?

A Yes, sir.

Q Now, did the deal come apart subsequently?

A Yes, sir.

Q What happened?

A Well, it didn't go through. I don't mean that to sound frivolous, but there were very serious conversations in the ensuing weeks, and meetings on weekends, and one Sunday night Dan telephoned me at home to tell me that he was not going to proceed with the understanding.

Q About how much later did that occur?

A Oh, on the order of magnitude of two to three weeks, I would think.

Q You mentioned a management task force. Can you describe the role of that task force in and about this time? We are talking about the first three weeks of August, 1969.

A Well, I recognized early in the tame that in a distress situation there are several different schools of thought, and it's a good idea if you want to get anything done, to let every school of thought have a voice in the decision-making process.

The schools constantly change as people left the firm, but I did bring together the chief groups of people, well, let's say one group of people the composition of which changed more or less constantly to participate in the key decisions.

Q Was James McDonnell a member of that task force?

A At times, yes, sir.

Q Was he on the premises of McDonnell & Co.'s headquarters office about this time?

A At times.

Q Did he lend any assistance in this salvage program?

A He was wonderful.

Q Tell me what he did.

A Well, he is a very intelligent and experienced businessman, and he was able to come in from his home and from his other businesses at personal sacrifice and attend our meetings and study the situation, you know, within the limitations of somebody who had not been in this business, and he did all that, what I would hope I would do if I was in his position

Q He was an officer of the firm at this time, wasn't he?

A No.

Q Didn't he occupy the title of vice oresident and run the Detroit branch office?

A I think that had been some time previous.

Q Did you raise any additional capital after the Lufkin deal fell through to sort of replace the expectancy that you had as a result of your negotiations with Mr. Lufkin

A Well, yes and no. We raised additional capital in the sense that we sold off assets for more than the value on the books. For purposes of maintaining our requirements with the New York Stock Exchange, that this was the raising of additional capital.

As far as the real new money coming in which I thought that Lufkin and others were going to provide, it never did come in, but there never was a moment that we stopped trying. For months we always had a new prospect as to which we were hopeful.

Q How much money did you raise in these other ways by selling assets for more than they were worth? Do you recall any figures?

A Oh, I would have to be general about that. It was in the millions, and not too far, I would say, from the six million.

Q Was the 6 million the figureyou hoped to realize from the Lufkin deal?

A Yes -- no, no. Excuse me. Lufkin was going to put together $3 million of new investors and we were going to sell off between 6 and $7 million worth of excess net worth.

Q And, as I understand it, you did generate $6 millic

A We did the latter in substance, yes.

Q Was the selling off of these assets which you mentioned sometimes called a plan of retrenchment?

A That was one of the terms used, yes, sir.

Q What kind of assets did it involve selling?

A Well, we sold several of the branch offices to others. We sold the Mc Donnell Mutual Fund. I remember we even finally sold the lease on the premises at a ssubstantial profit.

Q What was happening in the brokerage-financial industry at about this time, August, September 1969, how were conditions going?

A They were very poor.

Q What was happening?

A The volume on the New York Stock Exchange was sharply down from prior levels. The value of equities declined, which meant that much of the capital in these

investment banking houses which was in the form of common stocks was diminishing. It was a very depressing decline all the way around.

Q Were there times during this period when you saw any hope?

A Oh, definitely, Definitely. I established the practice of getting a little computer printout every morning as to how many trades had been executed by the 26 offices of Mc Donnell & Company the day before and there were times when you definitely had an up beat and a hope. There were times, of course, when the stock market would have a few good days and the hope is the father of the thought. YOu believe that the problem was going to work its way out.

Q Who devives the plan of retrenchment and the plan of selling off the assets to raise the $6 million, whose idea was that?

A You know, it was originally done by the staff of Mc Donnell & Company. I don't know exactly who they were, but most businesses will have what we call a Black Friday Plan, what would we do if everything were to turn purely on us. When I got there they did have such a plan. We deliberated that quite a bit. I would think that the management task force, which I mentioned a moment ago, was responsible for refining and implementing those parts which seemed

feasible.

Q In your search for new capital, did James McDonnell lend any assistance?

A Oh, yes, he was wonderful. Yes.

Q Can you tell us what he did that you recall?

A Well, in substance he did the same thing we all did. He went around and tried to find a fat cat who was interested in investing in an investment banking house. I recall that he brought in a man named Joseph Meehan one afternoon.

I think he had conversations with a Mr. Max Fisher and together we talked about Henry Ford. I think -- I don't know what all he did, but I do know that, you know, he did everything in his power to safe this firm.

Q Are you familiar with the capital reorganization that occurred at Mc Donnell & Company in the September, October time period in 1969?

A Yes, sir.

Q Can you describe to me what the mechanics of it wer and what the objective of those mechanics was?

A In detail it was enormously complicated, but in substance the mechanic was to convert the interest of some of the subordinated lenders, whose interest was a credit against the corporation, into equity of the corporation.

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That is what we did. It involved more than one step and a great many drafts. But that was the objective and that is what we did.

Q At or prior to the effectuation of the plan did you have any discussions with Margaret Murphy in connection with her consent to that plan?

A Well, I am sure I did.

Q Do you recall what you told her?

A I don't believe I told her anything different from what I told everybody else. I think I tried to conscientiously from the beginning to establish and open communication with everybody who had a substantial interest in this problem, and I think I kept them informed on a continuing basis of the risk to the firm.

I am sure I informed all of the subordinated lenders, Mrs. Murphy among them, that the conversion of their subordinated position into equity for the firm was one last hope.

Q Whose idea was the reorganization, who came up with that plan?

A I couldn't swear to it, counsel, but I think it originated with Sherarman & Sterling who were the legal counsel for the firm.

Q Would that be Mr. Tom Ford and his fellow lawyers?

A Yes, sir.

Q During the period that you were at Mc Donnell & Company did you have occasion to discuss its problems with representatives of the Securities and Exchange Commission?

A Yes, sir.

Q Did members of the staff of the Commission from time to time visit at the premises of Mc Donnell & Company?

A Whether they were members of the staff of the SEC or auditing firms sent in by the SEC is a fuzzy point in my mind. But certainly agents in one form or another of the SEC were in the house more or less continuously for months.

Q Did you have telephone discussions with any staff members or anyone else connected with the SEC?

A Yes, sir.

Q Do you recall some of the names of the gentlemen you spoke with at the SEC during this period?

A Yes, sir.

Q Can you tell us those names?

A Well, again yes and no. There were many what I would call kind of staff people from the SEC in the firm who would come and talk to me sometimes. Maybe it would be in the corridor or maybe it would be in my office, and I don't honestly recall their names because there were many and the exchanges were short. But I certainly did have more lengthy

exchanges with the chairman of the SEC and the chief enforcement officer in Washington, Mr. Pollack and Mr. Sporkin and subsequently toward the end with the regional administrator, a Mr. Duffy.

Q In respect to your -- was theone meeting with the chairman of the SEC?

A Yes.

Q There has been a memorandum that has been put into evidence by the plaintiffs, sir, which refers to such a meeting, describes it. I would like you to look at it and try to recall the meeting yourself and tell me whether that memorandum, which is Plaintiffs' Exhibit 67 is an accurate description of the meeting which you had with Chairman Budge?

A Yes, it is almost two pages and I didn't write it and I didn't receive it. May I read it?

Q Yes, sir.

I appreciate you didn't write it.

(Pause.)

MR. BROOK:S Let me just say for the record this is a memorandum by Mr. Newman dated January 22nd, which is a memorandum of a meeting supposedly had on January 22nd, which is Exhibit 67.

MR. BEEBE: I would also say for the record

I agree that it is in evidence. Our records indicate there was some ambiguity on it, whether it has been identified or marked in. We are both agreed it is in evidence.

MR. BROOKS: That's what my annotation says but I will have to be guided by the record.

A Yes. I have read it quickly and I do recall seeing this at my deposition a year and a half ago.

Q Isthat an accurate description of the meeting you had with Chairman Budge, sir?

A Not at all.

Q Tell me the circumstances of your meeting with Chairman Budge and essentially what was said by you and what was said by the chairman or whoever else was in attendance.

A Well, late one afternoon, I gather it was around January 20, 1970, I received a telephone call from somebody. This says that it was a columnist in Washington named Jack Anderson. If it wasn't he, it was somebody in Washington, telling me that Mr. Anderson was about to run a column on the Mc Donnell & Company situation.

I mentioned it to one or two of these senior people who were advising me and they were concerned about the impact which such a column could have upon the investing public.

Believe me, if a sensational kind of story were to

appear causing the public to believe that a major senior firm were about to go up the flu, it could cause investors to become anxious about their money and come into other firms and claim it.

So I called up the office of the chairman of the SEC who was at the time Mr. Budge and identified myself to his secretary and said I would like to come down and see him the next morning at 9 o'clock. She called right back and asked me to come.

I met with Mr. Budge at 9 the next morning in the company of Mr. Harry Lindh, who was then senior vice president of McDonnell & Company in charge of operations. Mr. Budge told me somewhat sternly that they were receiving a great many complaints and pressures from Capitol Hill about the conditions on Wall Street and that I believe the figure 23 per cent of them related to McDonnell & Company and that he wanted to have us fish or cut bait.

So I explained to him what the situation was, what we had done, what the progress had been, and I had cleraly identified in my own mind the night before that if we had about six weeks more we could probably get done about all that could be done. I didn't ask for six weeks. I was simply informing him of the risk that might be avoided with six weeks more of effort.

He was very sympathetic and really very responsive and brought in Mr. Sporkin and Mr. Pollack,

and Mr. Lindh and I then spent most of that day with those two gentlemen.

This memorandum, if you want me to respond to this memorandum, is quite inaccurate in a very important point, in that it says that the SEC promised me the six weeks. They didn't. I wish they had.

I went back to New York and every day for six weeks I wondered how muchtime we were going to be allowed. At the end of the six weeks I knew.

Q What happened at the end of the six weeks?

A Well, at the end of the six weeks a couple of significant things happened. One was that we received the report of the auditors of the New York Stock Exchange. I'll think of their name in a minute.

Q Let me stop you right there. Is the name Lybrand, Ross Brothers & Montgomery?

A That's right. And maybe they were representatives of the SEC.

Q I was going to suggest that they be retained by McDonnell & Company.

A I don't know who was paying their bill but their audit was the key thing.

Q Go ahead with that in mind.

A We had been waiting for months and months to find out if there was any possibility of their identifying this contingent liability, you see. And when they finally came along with their report and indicated that they could not, we knew that time was out.

Also it was more or less at that time that the SEC moved to impose sanctions upon the firm or individuals in the firm for prior practices.

Q How was the story of McDonnell & Company brought to a close mechanically? What did you do to essentially go out of business?

A Well, I called a meeting at First National City Bank of the auditors, the bankers and representatives of the New York Stock Exchange and presented them with my understanding of the facts and my conclusion that at that point it was not possible to continue the firm within the fules of the game. Specifically, the 325 requirement as to capital.

Q Was a liquidation then the result?

A Yes, sir.

Q Was a liquidation agreement signed?

A Between --

Q McDonnell & Company and a liquidator.

A I believe so.

Q I am trying to get exactly what you did mechanically on paper.

A Mechanically whatever you do when you decide to liquidate, we did it.

Q I thank you for your patience, Mr. McDonald. I'm through and I have no more questions on direct.

THE COURT: How long do you think you will be, Mr. Beebe?

MR. BEEBE: I am going to be long enough so I might suggest that it would be perhaps more --

THE COURT: You will need more than 15 minutes?

MR. BEEBE: More than that. I would say perhaps substantially more than that. I have a lot of questions to ask this man.

THE COURT: I will have to ask you to return at 10 in the morning, Mr. McDonald.

We will stand in recess until 10 in the morning, ladies and gentlemen. Goodnight.

(Jury left the courtroom)

THE COURT: For my information, what is the prognosis for this case?

MR. BROOKS: Subject to Mr. Beebe's

cross-examination of Mr. McDonald the stock exchange plans to call one more witness, Mr. Bishop.

THE COURT: Then you will rest?

MR. BROOKS: Yes.

THE COURT: What does your redirect case entail?

MR. BEEB E: I would say it's in the midst of intense review. It's being studied. It might not be very long. It depends in part on the cross of Mr. Bishop. The last witness that they are calling. I wish I could be more precise but I really can't.

MR. BROOKS: I should add that we plan to do about ten minutes worth of reading from the deposition of Fred J. Stock, adeceased officer of the exchange. It won't take more than ten minutes.

THE COURT: Then it might be that there will be argument on Thursday.

MR. BROOKS: I'm still worn out from yesterday's argument.

MR. BEEBE: I'm raring to go, sir. I think that Thursday would be a good thing to shoot for.

THE COURT: My problem is one juror is not going to sit Friday, which means I couldn't charge Friday anyway.

Do you anticipate that your closing arguments will be of the same length as the arguments on the motion to dismiss?

MR. BROOKS: I dont know, your Honor. I think that may be inadvisable. It's a long time to keep the jury's attention. I haven't finely focused on that.

THE COURT: I think a day should be allowed. I am not going to start charging the jury at 3:30 in the afternoon.

Why don't we plan, then, assuming we have gotten to thatpoint, that we have arguments on Monday and charge on Tuesday, regardless of when we finish the testimony?

MR. BEEBE: I think that is a fine plan.

THE COURT: I hate to separate the arguments from the jury's consideration by a weekend, plus my Friday motions.

MR. BROOKS: That would be agreeable.

THE COURT: All right.

MR. STEIN: In these circumstances then, unless anyone has any real objection to it, I will withdraw for the two days of testimony on the same basis that I did last week.

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THE COURT: All right.

(Adjourned to May 14, 1975, at 10 a.m.)

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